THE FINANCIAL CRISIS – A HISTORY OF THE ECONOMIC SCHOOLS OF THOUGHT

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Abstract
Crisis is a very important aspect of our everyday life and no matter of the dimension we refer to this represents a period in the evolution of a society marked by great difficulties and anxiety. From an economic point of view this is a normal and necessary event, leading to marvellous growth and development. Even so, the authorities are often not prepared or do not know how to mitigate and manage its shortfalls. The main objective of this paper is to focus around the financial crisis development in the perspective of Classical, Neoclassical and Keynesian economics. Even hundreds years apart, all of the three schools have captured the determinants, implications and some measures to mitigate the imbalances which are still relevant today. The question remains though, so why the world did not resolve the puzzle of financial distress taking into consideration the age of these types of events, the number and the forms they hit our society in the last decades. This study will try to summarize the main ideas of ones of the greatest minds of the past in order to bring some light over the financial crisis phenomena.

Keywords
Financial crisis, classical economics, neoclassical economics, Keynesianism, crisis theory.

JEL Classification
A11, B12, E12, G01.

Introduction

Globalization has increased the frequency and complexity of financial crises. Despite the multiple theoretical resources and the last century's experience a methodology or a process has not yet been developed to anticipate the economical failures. Some authors consider that these episodes appear as a manifestation of the interaction between the financial sector and the real economy (Kose 2013). Taking into account the experience of the past, the literature has developed various theories in the attempt of analysing and

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understanding the financial disruptions. The main objective of this study is to identify the attributes of a financial crisis in three major schools of thought: Classical, Neoclassical and Keynesian economics. The first step in any strategy is to understand the magnitude and complexity of the events so this literature review aims to assess the economic imbalances from a theoretical point of view.

Since the 18th century the economic shortcomings and the development of modern capitalism have been strongly interconnected, periods of prosperity being constantly challenged by periods of famine and poverty. The review starts with Adam Smith's perspective over the banking system which highlights the importance of the risk assessment and the relationship between individuals and the overall well-being of the society. After some years the crisis phenomena has been analysed as a troubling determinant into the real economy and the later scholars of Keynes and Minsky have distinguished the monetary from the real sphere. Furthermore, some social aspects like hoarding or speculative behavioural have been classified as triggers to financial distress. Even if it's normal for the economy to have a certain level of cyclicality, the extent and the magnitude of the critical episodes have to be controlled and mitigated in order to assure a healthy financial system.

The methodology of the study is represented by a comprehensive analysis over the papers written in the last 30 years. A systematic review of published studies has been performed on the main economic schools of thought, highlighting the characteristics of a financial crisis. As a starting point, mixed research techniques have been utilised by collecting and analysing the qualitative and quantitative information. A very important step was to differentiate the general ideas regarding economy of the ones related to the financial crisis. The next stage was to correlate the theoretical concepts with the facts and the reality of the times. The review of the empirical literature on the schools of thought is divided into three sections, each of them highlighting the main ideas of some of the greatest followers on how the financial crisis has exposed the fragility of the banking systems. The conclusions outline the commonalities and characteristics of Classical, Neoclassical and Keynesian distress. Furthermore, I have expressed my view over the similarities and the red flags our leaders should pay attention to in order to prevent the financial imbalances.

1. The financial crisis under Classical political economy

Classical economy is considered to be the first school of thought which has been born in the 17th century in Britain, the most important representative being Adam Smith (1723-1790), the father of economy and capitalism. Before that, economy as a science did not exist, being subordinated or included in politics, morality or religious. Its followers defined market economy as naturally supporting its freedom and correction. Furthermore, they identified a number of fundamental concepts such as production processes, the distinction between market price and natural price, the value of the good or the importance of trade and the goods movement. The Wealth of Nations written in 1977 marked the beginning of the classical school, supporting the idea of national incomes over the individual ones envisioning a free society where economy would work in the benefit of human kind. This theory laid the foundations of today's economic processes, capitalism and labour division (Farah N 2014).

The Crisis of 1772 mentioned by Adam Smith in his working papers is considered the first modern banking fall. During the Bengal hunger the East India Company suffered a major devaluation of the land and due to the company's significance in the British economy more than 30 financial institutions have gone bankrupt. The name of the crisis stems from the huge volume of loans attracted by the population and other private or public entities. The issues encountered by the East India Company caused an intense anxiety, this being known later as banking panic, most customers wanting to withdraw their deposits or request a reimbursement. This has automatically led to a severe contraction of the banking system, several financial institutions being forced to step out of the market. Rockoff (2009) likened this to the 2008 financial crisis, highlighting the lack of regulations and the absence of national institutions involvement. Similar to Lehman Brothers, the Ayr Bank bankruptcy from 1772 was the beginning of a deeply economic imbalance, both of them failing to excessive lending combined with poor management, lack of regulatory framework and any government intervention. In order to understand the banking system in Adam Smith's view, we must start from his two theories of monetary and credit (Ayed & Mondello 2016). The first one defines the positioning of money in the context of economy, their only purpose being to facilitate exchange. From this perspective banks have no active role, their only responsibility being to ensure the convertibility of banknotes into gold or silver. However, the money creation process should be controlled by the Government which must ensure that there is a balance between the quantities of precious metal and the issued banknotes. Therefore, the fragility of the banking system stems from the imbalances resulting from excessive lending. Basically, in order to cover the request for loans the banks will issue more banknotes and will automatically release more liquidity into the market. At the same time, the financial institutions are responsible for validating the debtor's reimbursement capacity and the assets brought as warranty. Smith considers that the monetary deficiencies are the result of several factors such as: non-compliance by the institutions which issues banknotes or other securities used for conversion and their lack of liquidity, solvency underestimation, poor management of banks and the absence of control over the banking system from the National Banks. Even if this economic crash took place in the 1700s, we can identify most of the attributes of a financial crisis: information asymmetry, excessive lending, lack of regulation and liquidity, banking panic, inflationary processes and currency crisis.

Another key aspect identified by Smith are the two directions or typologies followed by the 18th century banks: the first category is the one in which the banks embraced an excessive level of risk due either to the use of capital, the solvency of the debtor or the proportion of liabilities; the second one is aligned to the entities that did not follow the trend of the moment, remaining anchored in the typical analysis of financial indicators, past experiences and medium to long term development. As we can imagine, most of the banks that went bankrupt during the crisis were from the first category. (Rockoff 2010) Adam Smith is called the father of economy because his vast contribution remained of interest for the modern society as well. He was one of the first who identified a financial crisis and linked it to risk enhancement and debt. Furthermore, he made assumptions regarding the role of money creation and its impact. He supported the

freedom and natural liberty of the markets, pointing out the negative effects of an inadequate level of government intervention.
Karl Marx's (1818-1883) views on capitalism are mixed. He was convinced that a company's profit and income would result from labour productivity rather than financial innovation or a free market. Capitalism is arbitrary, difficult to control and prone to financial crises. Moreover, the financial distress would severely affect the unemployment rate and the country's economic progress, the overall welfare being lost. On the other hand, capitalism contributes to unprecedented technological progress and innovation, allowing the expansion of industries and maximization of production capacities. In terms of cyclicality, Marx argues for the existence of industrial cycles up to ten years, during this time the production reaching maximum levels and enhanced profit rate (calculated as the value of the capitalization rate). (Carchedi & Roberts 2018) Like the political ideology he belonged to, the spike in prosperity was closely linked to the labour force. Following the same path, the economic expansion periods were defined as an over-accumulation of capital resulting from production maximization, a restructuring of the labour market by lowering the unemployment rate and improving living standards as well as increasing the consumption. During this upward period, the level of wages and thus the cost of labour would increase significantly, which would translate into a lower investment budget which in turn, would lead to an overall slowdown of the economic growth. With other words, the connection between prosperity and speculation is the need of the capitalists to maintain their profits up or even increase them. To do that, they will be willing to make some risky investments or attract more loans from the banks. This trend along with the reduce profitability of the market will lead to a significant volumes of debt which will not be able to be repaid. The crisis from a Marxist perspective appears as a result of declining consumption rather than a worsening of economic indicators, being an endogenous recurrent crisis, the recovery being generated by the crisis itself (Kliman 2015).
Pioneers of the economy, the classics identified the basic aspects of a sustainable performance of the state and its inhabitants. Moreover, all these aspects have been established on a moral and philosophical background, based on virtues such as prudence, vigilance, circumspection, character or firmness. This liberalization and independence of the state is entrenched to an individual with strong principles, who should govern in a dignified way, as once the individual incomes are increasing, the national ones would expand automatically. Taking these into consideration, the financial crisis is being seen as a consequence of excessive lending and imbalances of the money creation process.

2. The financial crisis under Neoclassical economics

Neoclassical theory it is built around the premise that the prices, production and distribution of income are established through demand and supply. Moreover, all the models developed during this time suggest that the monetary sphere is distinguished from the real economy, the money creation process being adjusted automatically in line with the market dynamic. The believers of this school rely on three principles: the main objective of individuals is to maximize utility and that of economic agents to maximize

profits, market participants act independently on the basis of a complete and accurate set of information and choices are made in an independent manner.
Johan Gustaf Knut Wicksell (1851-1926) explains the dynamics of capitalist economies by two return rates: the natural rate of interest and the money interest rate. (Detzer DK et al. 2015) The first one is the interest rate that would be established in the neoclassical financial market where the investments and savings level would co-depend without money interference. The interest rate would be established by the national central banks and inflation would happen in case of an inequality balance, the money interest rate being lower than the natural one and its correction would be possible only through the central bank's intervention. Otherwise deflation would occur. In other words, in an expansion phase both production and prices would increase or decrease in the contraction phase. This stage of expansion is initiated exogenously, leading to the increase of economic fragility and instability over time which will sooner or later be translated into a financial crisis.
Irving Fisher (1867-1947) argues that money is neutral, setting the price level of products and services being its only use. If we are to consider the economic cycles of expansion and recession, the amount of currency into the market can have medium and long term disruptive effects over the economy. For this reason the national banks priority is to balance and coordinate the coinage system. The most valuable legacy however, is the progress made on the impact of deflationary mechanisms. Taking into account the manifestation of the Great Depression of 1930 Fisher shifted the focus from identifying the timing of the economic cycles to the triggers. The increased optimism of investors along with the herd effect leads to price increases and inflation which translate into excessive lending. Thus, a speculative bubble is being created which will lead sooner or later to a financial crisis. The level of gross domestic product increases and the unemployment rate decreases, the overall economic well-being turning into deflation. Fisher argues that the speculative bubble and deflation are strongly related. Even if under the circumstances of a free economy the stages of expansion/inflation and recession/deflation are normal and necessary in terms of the evolution of the financial cycles, the balance lies in the central banks power to maintain a healthy level of deflation.
Joseph Alois Schumpeter (1883-1950) continued the economic cyclicality research, bringing to the fore financial innovation and entrepreneurship as possible triggers of the speculative bubble. When a new invention, a new product or service is being discovered, the interest of the economic agents is massively accelerated and with it the investment and the value associated to this. Most of the time, the volume of loans will increase because the banks are the ones to assure the financial power needed to continue the expansion. The thirst for new, significant and easy profits will translate to that herd effect that will materialize by increasing prices and production capacity, even if this expansion is not based on real indicators rather on what could be by the potential held by that new product. When the speculative bubble breaks, the demand and the price of the product will decrease, manifesting that phenomenon of deflation, resuming Fisher's hypotheses. This theoretical approach supports the existence of economic imbalances as the markets are dynamic and in a constant movement and adjustments, the financial innovation bringing value and progress. Like Fisher, Schumpeter understood the

importance of economic sluggishness and recession alternating periods and the devastating impact of financial crises.

The neoclassic cyclicality will remain a remarkable discovery with the note that neoclassical models have raised a number of controversies due to their diversity. Nonetheless several characteristics have remained relevant today: the different cycle's production and profitability process, investors' decisions relying strictly on profits increase, the industry positioning of the technological innovations or the income distribution. With regards to financial crisis they made a step forward in terms of triggers and factors which translate into a bubble and an economic distress in the end. They share the view of the classical followers highlighting the fact that all over the economic history, periods of recession, depression or downturns have been manifested and embraced as normal.

3. The financial crisis under Keynesian economics

John Maynard Keynes (1883-1946) is the main symbol of the school, author of the General Theory of Employment, Interest and Money from 1936 which was also the starting point of analysing the Great Recession of 1930. The doctrine allege that the demand is volatile and unstable, resulting in economic recession periods when this decreases significantly and inflation if increases. The answer to these imbalances is the cooperation and active involvement of national regulatory institutions through fiscal policies and national central banks through monetary policies. At the same time, supporters of Keynesianism endorsed a free market economy and a private and public sectors balance. The schools' followers shared the view of the business cycles as a period of economic ups and downs, the growth spike being a speculative bubble and the high decrease a recession. Keynes developed a model of monetary production economy which took into consideration the money, commodities or business production and profit. The uncertainty is another key aspect for Keynes when it comes to the strategies and the behavioural of the economic agents.

The most important developments in the process of understanding the financial crisis phenomenon was the identification of its attributes and the statement of some directions to be followed: (Detzer DK et al. 2015)

- The level of granted loans must be analysed extremely carefully, because if too much capital is released into the market, the financial institutions may not sustain the scenario of the credits not being paid back. However, a low level of liquidity can result in a decrease in investment power.
- The level of uncertainty influences significantly the individual's behavioural. Keynes believes that economic agents relies their future investments on what is happening now, without considering neither the past nor the economic forecasts. From this perspective, in an expanding economy the investors will risk more, leading to a shortfall in the financial balance over time. Nonetheless, Keynes mentions the herding and speculative behaviour for the first time, laying the foundations of behavioural economics.
- Keynes also brings into discussion the information asymmetry by highlighting the different expectations of the portfolio managers and brokers. A manager will be more

informed as he is acting in that field for some time so his decision will be based on experience, financial trends and the dynamic of the market. The broker will be led by the premiums or other financial rewards, making his strategy more exposed and hazardous. This gap turns stock market transactions into speculative operations with a fairly high level of risk and uncertainty. However, such trends can also be associated with other tricky markets such as real estate, gold or ecurrency

- The interest rate is determined at the demand and liquidity supply junction point. During an uncertainty period, financial market players will desire to hold more liquidity which will lead to an increase of the interest rate.

Another important indicator is the return on investment. As long as it is higher than the interest rate, the growth will be exponential and profitable. Otherwise, it will lead to financial imbalances, resulting in an increase of the unemployment rate and a decrease in the overall standards of living.

Despite the fact that most of the attributes of financial crises have been identified and debated, Keynes never centralized them in an economic model this being done much later by Minsky. It all started from a fairly simple mechanism named economic cyclicality, which have also been briefly noted by the classic and neoclassic economic schools of thought. This cyclicality involves the alternation of periods of economic growth and development with that of stagnation and recession. Clement Juglar (1819-1905) was the first researcher to identify such cycles of 7 to 11 years aligned to four phases: expansion, crisis, recession and stabilization.

Another follower of this theory is Nikolai D. Kondratieff (1892-1938) who claims the existence of longer cycles whose duration alternates from 40 to 60 years which consist of three phases: increase, decrease and an inflection point or stagnation. (Totir 2011) Even if the notion of repetition and the process itself is absolutely natural and logical, it is not possible to create a pattern or a predictability of the moment when a new stage will begin. Over the years it has not been possible to identify two economic cycles of the same length, complexity or manifestation, highlighting once again the complexity and dynamics of financial markets. Louca (1999) analysed Kondratiev's work and identified two main cycles 1790-1849, from the French Revolution of 1848, with a turning point after the Napoleonic Wars of 1815, and 1850-1896 with a turning point after the German takeover in 1873. If we follow this hypothesis, we will discover a third cycle during the World Wars I and II, 1896-1945 the inflection point manifesting in 1929 and a fourth cycle during the Cold War, 1949-1989 with the inflection point between 1968-1973. Totir argues the start of a fifth cycle in 1990. During these repetitive stages, all the economic sectors have been affected, the prices and interest rates values being in an opposite link, the growth period presenting high prices and low interest rates, followed by a change in their interaction in the recession stage. Even though these cycles were identified in 1925, the causes documented by Kondratiex remained equally relevant nowadays: inequality, opportunity and social freedom.

Joseph Kitchin (1861-1932) and Simon Kuznets (1901-1985) joined the Keynesianism schools focusing on the short cycle's recognition and analysis (those up to three years). Later on, they have switched to 15-25 years cycles associating them with fluctuations in population growth rates, unemployment or immigration, as well as the level of investment and infrastructure. (Kwasnicki 2008) The triggering factors were significant

different, from climate change, psychological or economic factors such as overinvestment, consumption level, exchange rate stability, etc. It has to be mentioned that the supporters of this theory have engaged the first complex scholars on financial crises, their underlying causes and effects on economic and social life.
Hyman Philip Minsky (1919-1996) questioned the fragility of the economic system in a closed economy but susceptible to speculative bubbles context. His theory was ignored for many decades until the 2008 financial crisis happened. Minsky argues that after a period of recession, market players will steer to safe investments with a low level of risk. As the economic climate improves, they will look for higher gains in a shorter time turning to speculative placements with an increased interest rate. This period is called self-sustaining as the economy is booming, investment levels are raising and the market is becoming much more dynamic and active. In the context of this hysteria, the market is no longer conscious to a company's solvency, focusing on its development potential leading to huge loans, risky derivative transactions, or capital imbalances. Minsky called this stage the Ponzi scheme but more recent studies associate most of the factors to creating a speculative bubble. When the market becomes aware of the size of the risks, the economy shrinks, debtors become insolvent, interest rates rise significantly and stock markets become unbalanced. After the recession, investors will turn their attention back to safer investments, marking the beginning of a new cycle. This direct link between the fragility of the economic system and the level of lending but also the optimistic views of the investor are still applicable today. Minsky called the three stages: hedge, speculative and Ponzi being among the first researchers to mention the human side and the behaviour of participants in the context of economic crises. (Wolfson 2002) This has been the foundation of today's behavioural economics and of the numerous studies which apply to marketing, PR or sales. Moreover, in the context of globalization and market liberation this area has become a very debatable and analysed topic. Although Minsky saw the economy as naturally unstable with investors being focused on potential gain and development at the expense of present solvency, his work aimed to identify measures to improve the economic stability and the overall well-being. The most important directions were the increase of the national regulatory institutions intervention, having the responsibility to control the ways and the level of expansion of the banking activity, the granted loans, the payment systems and solvency. (Minsky 1994) Once financial institutions are regulated, ensuring a controlled expansion of the economy the unemployment rate will reduce, resulting an increase in the standards of living. The financial crisis from 2008 validated his theory, demonstrating how the absence of a legal framework along with the eagerness of investors for immediate gains can cause an economic crash of international scale.
The followers of Keynesianism have brought to the fore the macroeconomics and the impact that government can have through monetary and fiscal policies on economic life. At the same time, they drew up the most complete and complex agreement regarding the determinants and mitigation of economic crisis.

Conclusions

All these theories have captured in one way or another, the essence of the financial crisis, those speculative bubbles followed by an economic destabilization. We learnt

from the classics that the fragility of the market is sustained by excessive lending and the lack of regulation; moreover, they grasp some knowledge around the economic cycles as we know them today. The neoclassics have made a step forward in the cyclicality theories, highlighting the drivers and the nexus between capital markets, currency issues and financial innovations. The followers of the Keynesian school of thought have brought to the table the behavioural implications and their importance in the process of financial distress. At a financial market level, a boom will create inflation and a maximisation of the production level which will lead to that over-accumulation, damaging the human resources cost balance. Another important attribute is the behavioural drive, most researchers highlighting the importance of the market feedback, the herd effect or information asymmetry. Going further there are two hypotheses: an objective one represented by the market response which can be translated into changes of prices, interest rate, income or cash flow and the subjective one engaging the collective opinion of the market participants which can take the form of a negative or positive feedback that will translate into a certain economic trend. The neoclassicism supports the objective theory compared with the Keynesianism who attributes a greater importance to human behaviour. All of the three schools of thought consider that the determinants of the speculative episode are exogenous factors: a new technological innovation, the end of a war, the absence of a legal framework or a political crisis. Despite the fact that the interest rate often negatively affects the development of a financial crisis, central banks cannot be considered the main pawns in restoring balance. During the speculative bubble, the economic fragility accentuates more and more, this being the resulting product of several factors both exogenous and endogenous. Of all three economic schools of thought, Minsky has developed the most complex model for understanding financial crises. It was based entirely on Keynes's theories, adding economic indebtedness both as a way of destabilization and as a way of growth and development.

From a general point of view, I think that all of the three economic schools of thought comprehended the implications of financial crises in line with their times, captured the triggers and proposed some measurements to mitigate its effects. This also answerers the question of why the events still have a massive negative significance to our quality of living. The financial crisis episodes have developed in line with the economy, so what used to work 500 years ago it’s not applicable anymore. The globalisation, the development of industries, the internet discovery, the environmental issues and the political tensions have conceived some new variables in the equation of the financial crisis. Adam Smith’s theories were the base of our economy from multiple points of view, each of his forgoers continuing to build its structure as we know it today. In a way, the understanding of a financial crisis along with its causes, the impact and consequences as well as the measures to be implemented for economic recovery were established many hundreds of years ago. A speculative episode synchronized with an increase in loans and public debt will always lead to an economic crash of various proportions or structure. Each episode is different, though similar to the economy; it is a living organism in a continuous adaptation and transposition to the new financial mechanisms and processes. Their disappearance is impossible, the objective of the

authorities being to control them, as at the economy level such processes are not only favourable but actually healthy.

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