EXPLANATIONS OF FINANCIAL CRISES IN THE CLASSIC THEORY AND IN THE THEORY OF REFLEXIVITY

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Abstract: *Financial markets and economic activity suffered severe crisis from 2008 which made necessary to review the underling economic theory and to analyse different points of view.*

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1. INTRODUCTION

The financial history has shown that major financial crisis, related with the disturbances into real economy have the same pattern of occurence: a period of prosperity (after a period of disturbances such as war, social upheaval, natural disaters) characterized by great confidence followed by unproductive investments and speculations and than a sudden stops generate by events without an apparent importance.

Their occurrence is explained by the classical theory through the aggregate demand shock and its impact on the natural rate of output (at this level, economy being considered in equilibrium). From Soros' point of view the financial markets are inherently instable and the concept of general equilibrium has no relevence in real world. Also he advocate the importance of credit and money, these and real phenomena being connected in a reflexive fashion, influencing each over mutually. He also review the concept of the market as being always right, and the fact that its participants act by choosing the best aviable alternatives. In his view the market is wrong and its participants operate with bias which influence the course of events. The chain of causation does not lead directly form fact to fact but from fact to perception and from perception to fact. Because the world is no perfect, people does not act on the basis of perfect knowledges and the economic equilibrum (when the allocation of resources is optimum) it does not exist. That is why we should rethink the relationship between the participants' understanding and the situation in which they participate.

Although Soros' theory is base on the analysis over twenty years of financial evolution and it does not take into account the financial and economic history, there are some points of view which deserve to pay attention.

2. EXPLANATIONS OF THE CLASSICAL THEORY

The main assumptions of classic theory is that in the long time price are flexible and the amount of output depends on the economy ability to supply goods and services, which in turn depend on the supplies of capital and labor and on the available production technology. In short run, the assumption is the prices are sticky and the output depends on the demand for good and services (which are influenced mainly by fiscal and monetary policies). The aggregate demand is the relationship between the quantity of output demanded and the prices level and the aggregate supply is a function of potential rate of output and the differential between the level of expected price and the real price. In the classic theory the equilibrium is at that point at which aggregate demand and supply cross at

that level where output is at its natural rate and the prices are those are expected.

On the base of these assumptions, the boom and bust markets evolution can be explain in this way: the economy begin in a long run equilibrium but when aggregate demand increases unexpectedly (because of social upheaval, wars, discoveries of new technologies), the price level rise from the price of equilibrium to o higher lever causes the economy to boom. Because the price level is above the expected price, output rises temporarily above the natural rate, as the economy moves along the short run aggregate supply curve to a new point. Yet the boom does not last forever. In the long run, the expected price level rises to catch up reality causing the aggregate supply curve to shift upward. The economy returns to a new long equilibrium, were output is back at its natural rate and the expected prices are higher. In this process, according to the classic theory the shock generated by monetary supply is not the single and the main reason of the financial crisis.

3. SOROS' EXPLANATION

Soros consider that the concept of equilibrium is deceptive: since the adjustment process is supposed to lead to equilibrium, such a position seems somehow implicit in the observations. His starting point is that the equilibrium itself has rarely been observed in real life-market, prices having a notorious habit of fluctuating. The process that can be observed is supposed to move toward equilibrium but it is never reached. The market participants adjust to market prices but they may be adjusting to a constantly moving target. In that case, calling the participants' behavior an adjustment process may be a misnomer and equilibrium theory becomes irrelevant to the real world. Although the equilibrium is never reached, this does not invalidate the logical construction. The problem is, in Soros' view, that when a hypothetical equilibrium is presented as a model of reality a significant distortion is introduced. For classical theory the basic axiomatic approach is the theory of perfect competition that was first propounded nearly two hundred years ago and it has never been superseded; only the method of analysis has been refined. The theory holds that under certain specified circumstances the unrestrained pursuit of self-interest leads to the optimum allocation of resources. The equilibrium point is reached when each firm produces at a level where its margina1 cost equals the market price and each consumer buys an amount whose marginal "utility" equals the market price. The equilibrium position maximizes the benefit of all participants, provided no individual buyer or seller can influence market prices. It is this line of argument that has served as the theoretical underpinning for the laissez- faire policies of the nineteenth century, and it is also the basis of the current belief in the „magic of the marketplace".

The main assumptions of the theory of perfect competition are: perfect knowledge; homogeneous and divisible products; and a large enough number of participants so that no single participant can influence the market price. The assumption of perfect knowledge is not good assumption because understanding a situation in which one participates cannot qualify as knowledge. As the human knowledge problems began to surface, exponents of the theory propose a more modest word: information. The assumption of imperfect information is not quite sufficient to support the construction of the theory. To make up for the deficiency, modern economists resorted to the idea that that the demand and supply curves should be taken as given, arguing that the task of economics is to study the relationship between supply and demand and not either by itself.

Demand may be a suitable subject for psychologists, supply may be the province of engineers or management scientists; both are beyond the scope of economic.

Because the supply and demand and independently given, an additional assumption has been introduced. Participants are supposed to choose between alternatives in accordance with their scale of preferences. The unspoken assumption is that the participants know what those preferences and alternatives are. But the

shape of the supply and demand curves cannot be taken as independently given, because both of them incorporate the participants' expectations about events that are shaped by their own expectations. Their role is clearly visible in financial markets. Buy and sell decisions are based on expectations about future prices, and future prices, in turn, are contingent on present buy and sell decisions. The situation is not quite so clear-cut in the case of commodities, where supply is largely dependent on production and demand on consumption. But the price that determines the amounts produced and consumed is not necessarily the present price. On the contrary, market participants are more likely to be guided by future prices, either as expressed in futures market or as anticipated by themselves. In either case, it is inappropriate to speak of independently given supply and demand curves because both curves incorporate the participants' expectations about future prices.

The idea that events in the marketplace may affect the shape of the demand and supply curves seems incongruous to those who have been reared on classical economics. The demand and supply curves are supposed to determine the market price. If they were themselves subject to market influences, prices would cease to be uniquely determined. Instead of equilibrium, we would be left with fluctuating prices. This would be a devastating state of affairs. All the conclusions of economic theory would lose their relevance to the real world.

The demand and supply curves are presented in textbooks as though they were grounded in empirical evidence. But there is scant evidence for independently given demand and supply curves. In markets the prices are continuously changing, the participants being much influenced by market developments, the commodity, stock, and currency markets confirms that trends are the rule rather than the exception.

The theory of perfect competition could be defended by arguing that the trends we can observe in commodity and financial markets are merely temporary aberrations which will be eliminated in the long run by the „fundamental" forces of supply and demand. The trouble with the argument is that there can be no assurance that „fundamental" forces will correct „speculative" excesses. But it is just as possible that speculation will alter the supposedly fundamental conditions of supply and demand.

In the normal course of events, a speculative price rise provokes countervailing forces: supply is increased and demand reduced, and the temporary excess is corrected with the passage of time. Soros invoke here the foreign exchange, where a sustained price movement can be self-validating, because of its impact on domestic price level; the stock market, where the performance of a stock may affect the performance of the company in question in a number of ways and the international lending where excessive lending first affect the debtor countries' ability and willingness to repay the debt. The question is if these exceptions that confirm the rule, or do them necessitate a revision of accepted theory and the answer depends on the frequency and severity of their occurrence. Soros considers that is not possible to understand macroeconomic developments without taking the phenomenon into account. **A** world of fluctuating exchange rates and large-scale capital movements is characterized by vicious and benign circles in which the „normal" pattern of causation, as defined by classical economics, seems to be reversed: market developments dictate the evolution of the conditions of supply and demand, not the other way around.

In his theory of reflexivity the main assumptions are: imperfect understanding, the social science problem and the participants' bias. The issue of imperfect information is analyzed by comparing the position of participants with that of natural scientist. The basic idea of imperfect information is that unlike the other science which has an objective criterion at their disposal, bat the participant thinking is not independently given: it is contingent on their own decision, making the validity of participant view deficient. The problem of social science is that the scientific method is designed to deal with fact, but the economic events do not consist of fact alone, introducing an element of uncertainty into the

subject. Although it could be a similarity between the uncertainty principle of Heisenberg and the uncertainty introduce by the participants' thinking the parallel is misleading because in the first case uncertainty is introduced by the outside observer and the later case the by the participants. The participant bias can be indicated by the course of events different from the participant expectation.

The reflexivity in Soros theory is a function which can be describe as a pair a recursive function: cognitive function in which the participant perception depend on the situation and the participating function where the situation is influenced by participants' perceptions. In the cognitive function the independent variable is the situation and in participating function it is the participant thinking. When both functions operate at the same time, they interfere with each other, and this interaction is called reflexivity. The two recursive functions do not produce equilibrium but a never-ending process of change that made historical processes shaped by misconceptions of participants. Unlike the reflexivity theory the equilibrium analysis eliminates cognitive function which is replaced with the assumption of perfect knowledge. If the cognitive function was operating, events in the market place could alter the shape of demand and supply curves (which are expression of the participation function only) and the equilibrium never be reached.

Because the process of adjustment does not lead to equilibrium, the conclusions of economic theory are that they remain valid as deductions but they lose their relevance to the real world. His conclusion is if we want to understand the real world, we must divert our gaze from a hypothetical fins outcome and concentrate our attention on the process of change that we can observe all around us. But it will require a radical shift in our thinking because a process of change is much more difficult to understand than a static equilibrium. The first step is to revise many of the preconceived ideas about the kind of understanding that is attainable and satisfy ourselves with conclusions that are far less definite than those that economic theory sought to provide.

His point of view is that boom and bust evolution of the economic history was affected by the level of credit complicated by influence of economic policies. One of the flaws of classic economy is that it does focus mainly on the real world and neglected the problems connected with money and credit. Money are not the simple mirror of the state if affairs in the real world, valuation being a positive act that makes the impact on the course of events, they are connected and influence each other mutually.

The relationship manifests most clearly and the use and abuse of credit. Loans are based on the lender's estimation of the borrower's ability to service his debt. The valuation of the collateral is supposed to be independent of the act of lending; but in actual fact the act of lending can affect the value of the collateral. This is true of the individual case and of the economy as a whole. Credit expansion stimulates the economy and enhances collateral values; the repayment or contraction of credit has a depressing influence both on the economy and on the valuation of the collateral. The connection between credit and economic activity is anything but constant - for instance, credit for building a new factory has quite a different effect from credit for a leveraged buyout. This makes it difficult to quantify the connection between credit and economic activity. Yet it is a mistake to ignore it. The monetarist school has done so, with disastrous consequences. The reflexive interaction between the act of lending and collateral values has led Soros to postulate a pattern in which a period of gradual, slowly accelerating credit expansion is followed by a short period of credit contraction-the classic sequence of boom and bust. The bust is compressed in time because the attempt to liquidate loans causes a sudden implosion of collateral values.

The most important conclusion of Soros analysis of his theory of reflexivity in the real world (the stock market, the currency market, and the international credit market from 1982 onward) is that credit matters, not money (in other words, monetarism is a false ideology), and, second, that the concept of a general

equilibrium has no relevance to the real world.. Financial markets are inherently unstable.

Unlike the most accepted points of view, which consider the financial market as being not important for economic evolution. In this respect, the main effects of financial markets over the economic evolution financial systems are to produce information ex ante about possible investments and allocate capital, monitor investments and exert corporate governance after providing finance, facilitate the trading, diversification, and management of risk, mobilize and pool savings, ease the exchange of goods and services. In Soros view the financial market, especially credit market is determinant for the economic evolution.

8. CONCLUSIONS

For classical theory, the financial market is not the main preoccupation, being rather neglected, it role being seen as secondary in economic evolution. Although the real variables are and should be the main aspects to be analyzed is necessary to rethink the role of financial market, especially the credit market and its impact on evolution of real variables. Also it is necessary to take into account the possibility that the accepted theory about the market and its participant to be reviewed. I thing that taking into account these aspects when we try to find explanations about recurrence of financial crisis, is possible to find an answer to the question why the classical theory is not enough to make us not to repeat the same pattern of behavior from the past.

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