

ECONOMIC CRISIS, ITS PROSPECTS AND CHALLENGES FOR ECONOMIC THEORY

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***Abstract:** Actual crisis which originated from USA quickly spread throughout the world economy. Although at the beginning it was labeled as exclusively financial one, after its second wave (in 2008) everything became much clear. Finally we all became aware of its overwhelming influence on both financial and real spheres of national economies as well as global economic system. Being interested in what is obvious at the moment, in the first part of this paper we are going to describe (as much concisely as it's possible) reaction of economists to its emerging and further developing, focusing primary on short-term measures and policy responses to crisis. Second part of the paper is devoted to more fundamental questions of economic science: Was this crisis predictable? Which type of crisis it represents? Is the crisis itself capable of jeopardizing mainstream dominance?*

Key words: economic crisis, economic theory

JEL codes: F4; G17

1. INSTEAD OF ORDINARY INTRODUCTION

Like many times before, world economy happened to be somehow caught in a trap by events that represented first symptoms of global crisis. So, it took for a while that economists recognize crisis' potential. According to recent reports (UNCTAD, 2008), world economy notes a fall in growth of output since second half of 2007. In 2007 that rate was 3.8%, last year it was 2.5%, and prognosis say that for this year (even for those who are optimistic) more than 1.6% can not be expected. Judging by measures for easing and overcoming of the crisis, it seems to have the following key characteristics: first, the crisis has spread throughout financial, as well as the real sector (slowing down of industrial production, export and GDP), so it is impossible to be overcome without state intervention; second, taking into consideration its actual and potential consequences, the crisis will demand deeper, fundamental, structural changes; third, according to the prognosis and expectations, it will be most troubling for those economies that experienced excessive indebtedness and constantly present budget deficit.

2. WHAT TYPE OF CRISIS WE ARE FACING WITH?

In order to see implications of economic as well as political aspects of global crisis, it is necessary to answer the question concerning the kind of the crisis. Generally, there are three types of crisis (D Arcy, 2008). First, and least dangerous, is crisis caused by interaction of bad events such as external shocks (for example increase of prices in a world market) and imbalances on the level of national economies (when spending falls behind production). This leads to the decline of GDP and rise of unemployment. Strategy for a fight against such kind of crisis is different for each country: although expansive fiscal policy has been more often chosen, there is

also a possibility to decide on so-called „not doing anything“, when an economy is left to the „mercy“ of the market mechanism.

Far more serious is the structural crisis in which a certain way of organizing production becomes out of date; in this situation fundamentally economic changes are necessary in order to return the economy to development path. Like it was in the period of Great Depression (1929-1933) when the concept of Keynesian restructuring has enabled going through structural crisis, and in period of stagflation (in the 1970's) when neo-liberal ideas did the same thing. The biggest threat is represented by so-called systemic crisis in which an economy is facing with problems that have no solutions inside of an existing production system.

Current crisis is far from „ordinary“ crisis of the first type; having in mind the warnings from economists that the modern capitalism (which is built on a foundation of stimulating private spending) has become structurally unstable (Stanford, 2008), it seems that this kind of diagnostics implicate that we are dealing with a structural crisis. Will it grow to systemic one, depends strictly on inner options the system has at the disposal “for restructuring itself to restore profitability and growth” (D'Arcy, 2008).

In response to current financial crisis, developed countries started to apply bundle of measures focused on securing the liquidity. Besides, programmes supporting banks as well as other financial institutions have instantly been initiated. These are extremely complicated measures, and every country is free to choose the combination of measures appropriate for conditions it is facing with. Even though they can postpone or prevent the collapse of financial system, those measures give a small hope for achieving long-term, real recovery. Given that this crisis has shown the limits of existing regulatory and supervision frameworks on national and world level, new rules and institutions (which would be directed to reducing of the systemic risk) are also necessary. This means that, apart from measures meant for resolving insolvency problems of financial institutions, some additional, reform steps should be undertaken. In that sense, one of the most important tasks is re-regulation of financial markets (Stiglitz, 2009) which at least partially will contribute to general economic stability. However, it will not be enough if fiscal part “of the story” is further neglected. Besides, nobody for sure can predict what consequences may produce this “concentration of financial capital via completing the integration of commercial and investment banking” (Panitch and Gindin, 2008).¹

3. HOW THE CRISIS MAY AFFECT AN ECONOMY (CASE OF SERBIA)?

What was Serbia's reaction to the announcement of economic crisis? Obviously, it did not represent one exception from the rule – unexpectedly and with surprise it accepted the news about economic “quakes” around the world. The fact that the degree of our integration in European and international economic flows is still on unenviable level is treated as quite justified reason for not becoming worried. We were constantly persuaded by government representatives that, owing to the above-mentioned fact, Serbia has some sort of „protective belt“, so the crisis will pass right by us. Even if we assume that this kind of reactions were made in order not to cause a mass panic,² there may be another (and more appropriate) explanation: “local” economic analysts seem not to be well “equipped” (no matter whether theoretically or practically) for dealing with such problem.

Second, in conditions of global crisis, economic policy in Serbia is not exposed only to usual difficulties – continuation of market reforms, restructuring of economy, and attempts in achieving macroeconomic stability. It is well known how high of a price transitional economies

¹ They warn that such solution for “bridging” the insolvencies of investment bankers is quite the opposite to the solution offered during the crisis of 1930's.

² Cycles can be treated as a kind of epidemic, which is characterized by either optimistic or pessimistic expectations.

have already paid in the form of transformational recession (while transferring from one institutional arrangement to another). Reduction of global economic activity, rapid fall of investments, bankruptcy of firms around the world etc., can not pass by Serbia: quite the contrary – it is evident and certain that the world economic crisis will sharpen existing problems and create new ones.

And that is just one more pressure point which will question measures designed and proposed with the aim to soften (minimize) the consequences of crisis. For less developed countries like Serbia, following things are very important: foreign financing will be more difficult and much more expensive than so far;³ exporting of goods and services will be sluggish because of contraction of world economy growth.

If we look at the “channels” that the world financial crisis is being transferred through, the banking sector seems to be protected from negative “overspills” (it was not involved in trading with risky securities, nor have the banks been exposed to contaminated *sub-prime* credits). Since the growth of Serbia’s key exporting markets is reducing, even with the share of export in GDP being relatively low (around 30%), this decreasing demand will certainly have an unfavourable influence on our economic activities.

The thing that is the most problematic for our economy is the fact that global contraction of credit activity is causing a standstill of capital inflows (loans and foreign investments), which will consequently lead to slowing down of growth rate.⁴ From October 2008 to January 2009 industrial production was reduced for almost 25%, whereas the export fell on the half of previous level.⁵ These are obvious and significant signs of crisis, which can not be neglected any longer. Besides, the EU is also affected by current crisis.⁶ Keeping in mind that (with the exception of countries from Western Balkan) member states of the EU are at the same time most important trade partners and main investors for Serbia, through these two “channels” further deepening of crisis is more than a certain.

4. HOW THE CRISIS MAY AFFECT ECONOMIC THEORY?

Every crisis encroaches on relations and structure of current order. The word crisis is implying that the breaking point (possibly a turning point or a major change) is about to appear in the development of certain event. In medicine a crisis is “questioning” the capability of organism to return to the state of normal functioning (with appropriate therapy). Metaphorically speaking, this can be applied to the example of any economy: above all, economic crisis is about good diagnostics of the problem, as well as testing of potential of one economy to “heal” itself, and challenging the experts in that area.

In the context of actual economic crisis the thesis that it simultaneously represents the signal for existence of crisis in economic theory and/or economic science in general has been revitalized. That is why the question of responsibility of economic science for that crisis is also more often mentioned. In that sense few different interpretations of responsibility can be distinguished.

Some consider that the dominant paradigm (neoclassical orthodoxy) as a starting point of economic policy should be blamed for existing crisis. Others are more inclined to idea of

³ Due to high risk-premium, financing of Eastern Europe is now the most expensive at the global market. (Global Financial Stability Report, 2008, p. 44).

⁴ About consequences caused by capital inflows and outflows, i.e. about their influence on macroeconomic variables, see: Reinhart and Reinhart (2008).

⁵ Even though it may look like an unpleasant incident in August last year, after few months it turned out to be a decreasing tendency after three years of stable growth.

⁶ Some important data concerning budget deficit, unemployment rate, national debt and economic contraction for every member of the EU were published on February 2009 at: <http://www.nrc.nl/>

“dispersion of guilty” on economic science in general, since its predictability failed once again (in other words, it didn’t manage to foresee the coming crisis). The third group of opinions claim that the responsibility of economic science can be checked indirectly – through testing the efficiency of proposed/applied measures meant for overcoming the crisis. Having in mind that economists have always been better in explaining the past than predicting the future, economic science seems to be (as usual) able to analyse the crisis and draw some conclusions from it.

It is true that proper conclusions can be valuable starting point in case of future crisis. But, what economists always forget is the following (and very important) fact: every new crisis is outstanding one; that is why economic science will certainly find itself “stunned” once again.⁷

Economic history has registered existence of economic crisis a long time ago, although they started to repeat periodically (on somehow recognizable way) during liberal capitalism (since then they have been known as crisis of hyper production). With the exception of Great Depression (dated from 1929 to 1933), the first half of the last century was characterized by “distorted” rhythm of crisis. That led to belief that capitalistic system, thanks to Keynes’ measures of economic policy, finally got rid of any crisis (since that crisis suffered ultimate defeat). At the time Keynes was declared as the „saviour of capitalism“, and the economic science was proud of achieved consensus (personified in the sentence “we are all Keynesians“). In 1973 the energetic crisis, caused by “oil shock” was actually the first meaningful economic crisis after the Second World War. Since then, the Keynesian theory loses its impact, and its position was taken over by monetarist (neo-liberal) conception (Heilbroner and Milberg, 1997). Great opponents of state intervention (like Friedman) suggest measures of deregulation and re-privatization in the function of revitalizing economies. And actually, the mentioned measures have been successful in solving the stagflation as the most troubling problem of that time. However, exactly due to deregulation, it has been generated financial crisis in USA (in the middle of 2007), which then spread throughout the world.

Innovativeness of neo-liberalism has culminated in creating so-called “shadow banking system” (Gupta, 2008). Since it has contained a lot of non-transparent, complicated instruments, involving different processes or aspects, it was difficult to be understood, let alone to be dealt with. That’s why it evaded existing regulations with ease. On top of everything, the Federal Reserve did not make any constructive effort to prevent worsening of the situation. Therefore, by not interrupting illegal chain of activities, it was actually acting as an accomplice to the biggest financial crime in new history.

Officially, every country has taken *drastic economic measures* designed to lift the economy out of recession. As it was expected, they began on side of monetary policy – by pumping cash into the banking sector (Stanford, 2008). This was quite the opposite from Keynes’ ideas.⁸ What did they need? Speaking about the above-mentioned, re-regulation could be helpful – to prevent another similar crisis and to create safe and sound financial system.⁹ It would probably (and just temporary) slow down creation of financial “novelties”, which are supposed to be “must have” in global race; from the other side, it would at least postpone if not prevent the next crisis.

Judging by Keynes’ opinion – a fiscal policy could be more appropriate, but not any kind of such a policy. Proposed solutions directed to stimulate new cycle of investments *via* cutting of taxes were almost useless – most of them went to savings.¹⁰ Great economists of our time completely

⁷ “Economic theory learns nothing from economic history, and economic history is as much corrupted as enriched by economic theory.” (Solow, 1985, p. 328)

⁸ Precisely, treating financial institutions as the means to an end, and not the end itself, he had not believed in efficiency of such type of measures during heavy crisis.

⁹ However, it should not be reduced only to modestly strengthen regulations insisting exclusively on transparency without significant, substantial changes which can prevent any future crisis.

¹⁰ Exactly the same happened in the USA and Great Britain when such an idea occurred to neo-liberals.

agree that global crisis demands global solutions – like coordinated fiscal policy; at the same time, they are skeptical about “feasibility” of such a policy since change of the course from neo-liberalism to Keynesian-ism may not be revolutionary – i.e. those better prepared will not miss the opportunity to “use” the moment of crisis for their own purposes, which can be even more profitable for them than under market fundamentalism (Stiglitz, 2008; Krugman, 2009).

From the point of view of economic science, moment for questioning the dominant neoclassic paradigm has come.¹¹ Besides, actual crisis will probably reaffirm some of the unfairly repressed ideas. Therefore, in the conditions of exponentiation of economic regulations and managing which relies on changing rules of the “game”, we can expect comeback of Keynesian ideas as well as opening of additional “room” for conception of institutionalisms.

What is the key word and common denominator of most of the explanations concerning the crisis? The right answer is: greed. That is why we would like to emphasize that the main point does not refer to complete discredit of well known philosophy that markets are self-correcting (Krugman, 2009; Stiglitz, 2008). “Pure” market economy (in Adam Smith’s sense of the word) takes into account ethical considerations and is more inclined to right regulation than to deregulation. And what we nowadays practice is its distorted version, an “anarchic economy” (Lampe, 2008). In other words, a bundle of contradictions that arose and flourished within that system are more responsible for crisis than neo-liberal ideology itself (Panitch and Gindin, 2008).¹²

In confrontation of different theoretical concepts, the best prospects for victory has the one that succeeds to incorporate in its theoretical model the parameters that describe the real economic system (in other words, the one that has the best “communication” with the economic reality).

Why is it, in spite of the fact that the crisis are immanent in every economy, so hard for economic science to predict and eliminate them? Economic dynamic are consisted of two types of changes: a) cyclic (repeatable) and b) evolutionary ones (not repeatable). If the crisis can be characterized only by the cyclic kind of changes, it would be realistic to expect that economic science has learned something from previous experiences, so it can cope with them successfully. Far bigger “bite” is represented by evolutionary changes that make it impossible for economies to go back to the same position in which they were in the time of the previous cycle.¹³

Unfortunately, paradigms and economic theories that successfully prove their superiority, express the tendency towards conservation (i.e. they became somehow robust). On the other hand, real economic life is constantly changing, which broaden the gap between rigid theory and real economic system. Also, since the rules of the game are not questioned, they are not in accordance with economic practice.¹⁴ In that way we can spot and follow the cycle of paradigm and/or theories shifting. Two biggest economic crises that have shaken the world during the last century were characterized by the following features: from all of the given *answers* to the *challenge* of those crises, accepted was the one that represented the best possible solution for that given situation.

¹¹ For more details about unchangeable and exclusive nature of this paradigm see: Hodgson, 2000.

¹² Panitch and Gindin distinguished neo-liberalism as “ideology” (meant to divorce market and state) from neo-liberalism as “materially-driven form of social rule”. Role of ideological component is now undermined; however, as a social rule calling for more regulation, it can be more dangerous.

¹³ According to the principle of paedomorphosis (which has been known in biology), «evolution may, as it were, retrace its steps, to make a new start from an earlier point» (Hodgson, 2001, p. 345). This principle can be applicable to different «evolutions», even in economic science.

¹⁴ Keeping in mind all of the complexness, dynamic and stochastic nature of economic system it is obvious that market “game” can not count on stable and long term rules.

Of course, as the time passed by, the “right answer” loses its pragmatism. That is why previously perspective theoretical concept is no longer capable to communicate with newly created changes in real economic system; this is an intro to new crisis.

5. CONCLUDING REMARKS

Concerning short-term policy responses, it seems that economists almost exhausted ideas they have at the disposal. Also, they explained and described in details rise, developing and culmination of the crisis. Yes, they noticed one by one almost every symptom which emerged in the meantime. They realized that we have many sick “persons” (number of which has been increasing), suffering from common as well as diverse “pains” at the same time. Surely, they were aware of the possibility that “illness” was becoming epidemic by nature and huge by its dimension.

What they did not do? They certainly cured the above-mentioned symptoms in the order of appearance, being no capable either to determine what really was wrong or how to make right diagnosis and prescribe the remedy. Although pointing at many imperfections of capitalist system in general, their critiques were not that constructive. Precisely, they offered *neither vision* of alternative system *nor strategy* how that more egalitarian (yet imaginary) system can be established.

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