Biuletyn Instytutu Zachodniego

No. 68/ 2011
12’10’11

INSTYTUT ZACHODNI
im. Zygmunta
Wojciechowskiego
Instytut Naukowo-Badawczy,
Poznań

Authors:
Marta Götz
Piotr Cichocki

Three years of crisis in global economy and economical thought

It has been three years since the fall of the Lehman Brothers bank and the world economic crisis seems to evolve and take on various new forms. The problems on the mortgage market first spread to the general banking system, then later moved on to attack the public finances of most countries and threaten the stability of financial institutions once again. The world shudders at the thought of the realization of the W scenario.

The hope that it is possible to deal with the depression at the first attempt, in the form of a V-shaped economical rebound, has virtually been lost. Uncertainty has become the most certain thing. The forecasts resemble fortune-telling and are additionally burdened with numerous reservations and conditions – in short, provisions in case of the occurrence of certain phenomena. The uncertainty of today is different than that from three years ago. It is not about the countries’ willingness to save the financial system institutions, but their very ability to do so. The doubts concerning the solvency of Italy, France and, in the long run, the United States ,show that the world economy does not have any more significant reserves or additional lines of defense.

Many diverse means were employed to combat the symptoms of the crisis on many fronts and taking different measures, some of which can be described as "doing by learning" – gradual adjustment and reaction while becoming more familiar with the nature of the problem. However, these tactical maneuvers do not seem to be driven by any coherent strategy of world economy management. In this sense, the current crisis resembles those from the thirties and seventies of the 20th century, because of the economic and financial difficulties which are accompanied by doubts concerning the stale paradigms of economic thinking. On the other hand, these doubts are now more often accompanied by reflections concerning the future and temporary paradigms, but the new Keynes or Friedman, presenting a coherent idea on how to change the course of economy, is yet to appear.

The politicians from the Western countries try to present, if possible, a homogeneous position in their declarative layer. Appeals concerning the help for banks and budget consolidation are repeated like a mantra in almost all of the world's capitals. Unfortunately, this homogeneity is not always visible in practice and the emphasized priorities make one wonder about the actual uniformity of goals and challenges. However, the divergence in economic policy on both sides of the Atlantic is, according the experts of the Breugel think-tank in Brussels, a justified necessity of adjusting actions to local challenges. In particular, it results from: various changes is productivity levels (or more generally, the different behavior of main macroeconomic categories), specific problems of national economies, such as high unemployment in the USA, diverse approaches to the means of dealing with crises and economic optimism (i.e. to what extent was the recession caused by the collapse of supply and to what extent by lower manufacturing capacity; in the USA the supply side optimism is more predominant, while in Europe – supply side pessimism) or institutional issues, such as the lack of central fiscal authority in the EU. The exceptional condition of the global economy requires special coordination of transatlantic relations (critical quantum of coordination). It should include: the obligation to avoid unilateral decisions, including currency depreciation, taking over of medium-term fiscal plans by national parliaments, cooperation with respect to the insufficient value of the Chinese yuan and strengthening the supervisory role of the IMF. The appropriateness of such coordination is supported by: the decreasing role of economic policy principles as a compass for transatlantic relations (e.g. the use of "heterodoxical" instruments which, taking into consideration the classical economic policy directives, question predictive capabilities), the influence of spreading processes and "mutual market infection" (lack of the so called decoupling), the increasing risk of protectionism and fear that the lack of transatlantic agreement will be used by China for its economic benefit, and that the current situation will self-intensify even further (self-fulfilling prophecies).

While governing bodies band the necessity of coordinated actions around, economists more and more often ask about the sense of the steps undertaken. What was the final purpose of the works of the Financial Crisis Inquiry Commission (chaired by Phil Angelides) and its effect in the form of three inconclusive reports published? Not much has changed with respect to the so called market failure and its basic elements – temptation of malfeasance, herd effects and negative selection. The concentration of capital has increased. In the special report from March 2011, the IMF points to the condition of banks and related threats for the world economy (Crisis Management and Resolution: Early Lessons from the Financial Crisis, MF Staff Discussion Note, March 09, 2011). Before the crisis, the five major institutions constituted 307% of the GDP of the countries they originated from. Now, it is 335% of that GDP. According to the Fund, restricting the scale of operation of the largest banking institutions would actually improve the safety of the financial system. In Europe, more and more questions are asked about the sense of the successive aid tranches given to Greece, which is on the verge of bankruptcy.

The newest economic forecasts are not optimistic. The annual IMF report on the subject of the future state of the world economy predicts only "anemic" growth and warns against the suppression of economic growth rebound pace, especially in the USA, picturing a winding and bumpy road before the global economy. The global economy is entering a "dangerous phase" and the developed countries will face a period of "weak" economic growth, while the problems of the USA and countries of the euro area are to quickly drag them into recession. In the report from September, the IMF verified its predictions regarding economic growth – the forecasts for the USA were lowered by a whole percentage point to reach the level of 1.5% (mainly because of the problems on the job market) and by four percentage points for the euro area (in 2011, the economic growth is predicted to come to only 1.6%, while the earlier forecast was 2%). Soon after this rather depressing report was published, a meeting of the representatives of G20 took place. Once again, having mentioned the fragile state of the world economy, continuous efforts to reanimate the economic growth were appealed for. It was even announced, that central banks are to some degree obliged to help commercial banks in case of unfavorable development of the situation on the bond market which, because of the possession of such bonds in their wallets, would threaten the fluidity of many financial institutions. During that meeting, the countries of the euro area announced, that they will “do all that is necessary” to prevent the crisis and solve the problem of public debt.

At the same time, international institutions, led by the IMF, but also representatives of American administration and Chinese authorities, demand more decisive actions from Europe. Otherwise, there is a risk of “the destabilization of the situation in other parts of the world.” In the published statement one can read, that “the world economy entered a new, dangerous phase”, so “scrupulous observation of the situation, followed by the readiness to take decisive action” gains primary importance. All actions aimed at “helping the countries of the euro area, restoring trust, preventing debt crisis and reviving the world economy” were considered appropriate. Similar statements were made by the representatives of international banking during an annual meeting in Washington. They even warned about a threat to worldwide prosperity resulting from the prolonging crisis on the global markets and called for quick changes, especially within the EU European Financial Stability Facility (EFSF) – its rights and financial capabilities. According to many analysts, the decision of the American federal reserve to conduct the so called twist operation instead of the quietly awaited next round of quantitative easing (QE3), served as a cold shower for the market. The change of securities from those with short to those with long maturity is supposed to lower their interest rates and improve the situation on the mortgage market.

All the more or less synchronized actions are reflected in financial markets, where nervous currency exchange rate fluctuations can be noticed, together with the subsequent reactions of politicians and appropriate institutions. It is enough to mention the unprecedented binding of franc and euro rates by the Swiss central bank in August this year or the recent interventions of NBP in Poland. The spreading of problems from one area of economy to others, from the financial system to the production sector and job market, additionally intensified by increasing international interdependence, make the management of the global economy a very difficult task. The fragmentary nature of the often late reactions does not match the scale and character of the challenges. This is where the phrase “doing by learning” comes from, the reverse of the popular “learning by doing”.

It is very difficult to provide a uniform evaluation of the new economic policy solutions appearing one after another. On the one hand, for example, one can hear a lot of criticism depreciating the sense of the creation of new institutions. In reaction to the crisis, the EU took decisive measures and the new European architecture includes cautiousness on the micro and macro scale; the financial element with European Financial Stability Facility guaranteed by individual member states and the mechanism guaranteed by the EU budget, as well as the regulating and coordinating element in the form of the European semester using the annual economic growth forecasts based on the Europe 2020 strategy. Further steps – the French-German pact for competitiveness equalizing retirement age, the ban on the indexation of wages or the harmonization of CIT, all face criticism from countries (both peripheral and EU "core" – Austria and Holland) and influential economists, including the president of the IFO institute in Munich, H.W. Sinn. These steps prove, that the EU needs to redefine the dimension of economic cooperation. As some observers put it, the budding of institutions may lead to the inflation of bureaucracy and overgrowth of administration. What is more, in the case of the EU, this means bringing a new quality to the union through the back door, which seems rather undemocratic. On the other hand, the flexibility and swiftness of reaction to new challenges, instead of sticking strictly to the existing rules, should be approved of.

There is a discussion, not only among economists or decision-makers concerned with politics, but also in the public sphere in general, between the so called Keynesists, calling for more / further national interventionism and warning about the lost decade, following the example of Japan, and the representatives of the more orthodox trend, pointing to Greece as an example of the catastrophic results of uncontrolled consumption and malfeasances. Recently, they gained a new argument. The research conducted by American economists K. Rogoff and C. Reinhart indicates, that the 90% threshold of the relation between GDP and debt, when exceeded, poses a threat for economy, as the debt level then begins to hinder (or even paralyze) economic growth. The dispute on whether to "consolidate finances" or "stimulate economy" is accompanied by the debate concerning economic growth, which was so far considered to be a remedy for the majority of economies with problems. More doubts arise, especially in the face of the idea of sustainable growth as well as climatic and demographic challenges, in relation to the continuous stimulation of the economic growth and keeping its pace high. This gives rise to opinions depreciating this category and suggesting the necessity of changing the former view of economic growth.

One should not therefore be surprised by the doubtful narration getting more and more common. Will Greece really announce its insolvency? Will it leave the euro area? Or maybe Germany will do it, tired of its role as the last instance creditor? Is the USA FED going to apply another round of quantitative easing, the so called QE3? Will the participation of private creditors in case of the insolvency of any of the countries (the so called haircut) be introduced? If yes, what will it look like? We have been living for over thirty years in the age of a constantly increasing amount of questions, the answers given to which are different depending on temporary circumstances; it all lies within the area of short-term tactics, with little relation to long-term strategy. Shortly after Nixon publicly announced, that "we are all Keynesists", the neo-classical economic theory revolutionized economic thought; after three decades of domination of the neo-classical doctrine, another great crisis called into question the sense of current economic knowledge. If it is possible, after the currently observed period of doubt, to crystallize a new vision, ending or soothing the worldwide disorientation and uncertainty, still remains to be seen.