The Economic Crisis in 2008: A Breakdown of Institutions and Views

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What happened?

The many years of crisis-free economic growth in the West and the rapid growth of the high-tech sector led businessmen, politician, as well as regulators to believe that the global growth mechanism had cardinally changed: humankind seemed to have learned how to increase production without major recessions. This belief caused investors to underestimate risks. The first bell for the current crisis rang at the end of 2000 when the high-tech NASDAQ index plummeted (and never came back). Then two related "bubbles" exploded in the mortgage and oil asset markets: the first of the summer of 2007 and the other in August 2008.

A bubble, or pyramid, is the result of self-fulfilling optimistic expectations: investors believe that the demand (for a good or security) will continue to grow so they borrow and buy in order to sell at a profit. Buying causes prices to increase and encourages further speculation. But sooner or later the money stops coming in, prices stall, optimistic expectations yield their place to pessimism, and everybody makes haste to sell - the process reverses at an incredible speed causing numerous bankruptcies.

Economic growth theory demonstrates that bubbles may appear in economies where stock markets are nonexistent and agents accurately predict an infinite future. But in the real world it is the stock market that creates bubbles.

Bubbles have accompanied market exchange activities ever since these came into being. The first known market collapse in history has happened at the Amsterdam bourse in 1637; it was the result of tulip speculations. At the peak of the tulip frenzy, a third-rate tulip bulb was traded for a carriage and a couple of horses.

In the modern economy, financial markets and credit markets are thoroughly regulated to try to avoid bubbles. But these do occur from time to time often accompanying the recessive phase of economic cycles. So, maybe nothing special has happened and in a year or two the recession will make room for growth and everything will fall into place?

Doubts about such views are due largely to the scale of the market crisis: the capitalization of US companies decreased by an average of 40% in 2008 and the drop in the European stock markets was about 50% while Russian market indices were less than one-quarter of the pre-crisis levels.

Furthermore it is disturbing how the architects of the modern financial system and major Western politicians have reacted. The crisis seems to have undermined the very foundations of their philosophy of life.

Here is a quote from Alan Greenspan who headed the Federal Reserve for 18 years: "I made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms." (http://www.guardian.co.uk/business/2008/oct/24/economics-creditcrunch-federal-reserve-greenspan). And the world press has quoted Nicholas Sarkozy as saying: "The present crisis must incite us to refound capitalism on the basis of ethics and work … Self-regulation as a way of solving all problems is finished. Laissez-faire is finished. The all-powerful market that always knows best is finished." (http://euobserver.com/9/26814).

A number of researchers are asking the question of what innovations could become the engine of economic growth once the crisis bottoms out.

This seems to be the crux of the matter. The subprime crisis in the United States only triggered off the global crisis. Its true nature is a combination of two things. The first is the blind belief in the ongoing technological progress backed by market mechanisms. The other is the temporary shortfall of basic technological innovations (Mensch (1979)), the true sources of economic growth.

Beliefs in crisis-free future development (supported by many years of experience) and consequently expectations of rapid income growth can provoke a bubble in any market. But with the housing market being what it is – given its scale, long-term borrowings and multi-tier funding (with derivative securities) – it is the likeliest candidate for pyramid-building in this situation.

In other words, a global crisis evolves as follows. Decades of fast growth based on the next-in-line basic innovation (computers and Internet) nurture beliefs in the ongoing and accelerating technological progress, increased incomes of individuals and consequently effectiveness of large-scale investment. If the potential of the earlier basic innovation is exhausted before the new one appears, the abundant investments set the stage for collapse (in any market).

If this hypothesis is true, the Western world is facing a long period of stagnation until new discoveries (biotechnology? nanotechnology? solar energy?) lay the groundwork for economic recovery. "Keynesian" methods to encourage demand can only help to cushion the consequences of the downturn and stabilization. New scientific and technological policies are needed to emerge from the recession. An increased role of the government is bound to happen. An intuitive understanding of this appears to underpin the overhaul of the Western leaders' world outlooks.

It needs to be pointed out that the above concept calls for a profound analogy between the current crisis and the Great Depression. Prior to the Black Tuesday, US industry was known to have grown at an incredibly quick pace (up to 30% per year). The growth was based on new economic approaches (Taylor's theory) and mass-scale production of radios, electric home appliances and cars. Roosevelt was able to stabilize the economy but the stagnation effectively continued until World War II.

There is no doubt that the current crisis contains totally new elements. One of the reasons is that the (American) market had built a highly sophisticated system of derivatives gaining the possibility to engage in extremely risky behavior while passing the risks to other agents but it proved out of control for mass-market investors and regulators alike.

If that is so, what is required is not only the imposition of supervision but changing the basic principles underpinning financial market functioning.

A revision of views on globalization?

Bush disagreed with European leaders. He told a G20 meeting that "Free market capitalism is the engine of prosperity, progress and social mobility in economies worldwide" and that "All our countries must reject calls for protectionism, collectivism or defeatism in the face of the current challenge."

The United States has not always been such a zealous advocate of free trade. As they overtook and left behind Britain in the 1800s and early 1900s, the Americans steered stringent protectionist policies. In those days Britain was campaigning for freedom. Come to think of it, as it tried to catch up with the hanseatic cities four centuries earlier, Britain made wide use of custom duties and trade barriers.

It is the leader that benefits from a free global market in the first place. As it pushed for free trade, the United States offered to world stability (symbolized by its treasury bills) and the possibility to operate in the largest regional market and borrow American technology. The world responded with its belief in the US dollar, which enabled the United States to fund a visible part of its expenditures at the cost of the rest of the world. The current global crisis originating as it did in the United States is viewed as America violating this implicit contract. And its losses appear to be much less than the losses suffered by the developing markets and even by Europe.

This is the key difference in the views of the United States president and EU leaders on post-crisis development.

Protracted stagnation is likely to make the world more divided. The role of local markets and internal economic policies should increase.

Where are we?

Our per capita GDP is only about 30% of that of the United States and 40% of the UK, France or Germany. This is our key characteristic now. Our economy was growing in the last eight years largely thanks to revenues from the export of raw materials. The revenues fueled investment in related industries and generated demand for consumer goods, services and homes, with the impulse passed on to construction and further down the value chain. Things would have been quite all right if this had continued for another 15 years. But the window of opportunity has now been shut. No internal growth mechanisms have yet been created. What lies in the future - unless energetic and thoroughly elaborated policies are implemented - is the collapse of the real estate market, bankruptcy of construction companies, continued downturn in industry, unemployment growth so unusual for Russia, and a wave of strikes and, quite possibly, continued political clampdown. The earlier growth mechanism has outlived its usefulness. It is time to work on our mistakes and search for new growth strategies.

The advantage of being backward

A developing country has just one advantage before the developed nations – the possibility to borrow their institutes, technologies and economic approaches. This is easier and cheaper to do than develop something "fundamentally new." Still, it is an uphill job and an overwhelming majority of countries have failed to face up to it: a handful of the developing countries have become developed in the last 60 years. What should be borrowed and in what order, and how to adapt Western technologies and institutes to Russian cultural, institutional and technological realities? The government cannot answer these questions on its own. In the past two decades we have been building a GKO market, implementing a five-level progressive income tax scale and fish auctions, monetizing benefits, moving to a fully funded pension system, and building up security market institutes including a two-level mortgage market. As we borrowed the most advanced instruments, we assumed some of the design risks and paid the costs that could well have been paid by the more advanced countries.

One-quarter has survived of our stock market. There is no hoping that it will recover soon and in the near future we will need a more conventional funding institute – a reliable banking system. Paradoxically, the crushing security market forced the government to agree to partial deprivatization. The key threat now comes from too much centralization; given the historical experience this kind of "swing" should well have been expected. What I believe to be the only solution is to build a system of interactive growth management based on cooperation between the government, business and civil society helping to coordinate interests as large-scale industry modernization projects are designed (also see: Polterovich, 2008a, b).

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