World economy, economics and economic policy: what emerges after the crisis?

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Abstract

The paper analyzes the current discussions on the state of economics with special focus on the interrelationships between key ideas of economic theories and real actions of economic policy in the course of the global economic crisis. The global economic crisis showed the limited ability of mainstream in economics to service the economic practice, and, therefore, the attention of researchers and economic policy-makers was drawn again to some alternative views in economics.

Key words: economics, economic crisis, economic policy.

JEL classification: A1; E6.

The global economic crisis has increased the degree of debate in the world economic science on the relationship of economic policy and ideas of economic theory[1]. The economic theory itself has been subject to fierce criticism from public opinion and policy makers, especially in terms of the adequacy of its views about the economic realities and the obligations arising from these views, practical recommendations for economic policy. Among the mighty of this world, who asked pointed questions to economists, turned out even Her Royal Majesty Queen Elizabeth II.

This discussion from the very beginning got wide international press coverage. For example, in the summer of 2009 worldly famous London weekly Economist published two special articles with critical analysis of the main blocks of the new classical macroeconomics and financial economics [13]. The impressive magazine front cover showed a melting chocolate-milk textbook of economic theory... Critical articles on the current state of macroeconomics, prepared by high rank OECD official, appeared on pages of IMF published "Finance and development"[26;27]. Some economists start to speak with alarm that the Departments of Economics in universities, locked in exercises of abstract theory of the logical choice inevitably will lose a significant portion of the students in favor of business schools and faculties (departments) of applied disciplines[12].

The analysis of active global debate on the relationship between economic theory and practices of economic policies, which is going on with the participation of the most prominent modern economists, including Nobel laureates, as well as

[1] On pre-crisis debate see (2;4)

possible consequences of these discussions for the development of contemporary economic thought are of great interest for economics profession and policy makers.

1. The crisis, anti-crisis measures and the economic theory.

In terms of a number of indicators the global economic crisis, already known in modern literature as the Great Recession, is compared with the global economic crisis 1929-1933 known as the Great Depression. Both phenomena have much in common: a significant decline in production, high unemployment, and deflationary trends in pricing, fast decline in volumes of international trade. In either case, it required special anti-crisis measures of government economic policy, although there are differences in time when anti-crisis measures are started to be implemented. "New Deal" of President F. D. Roosevelt began to be realized when the US economy already was in the doldrums and the practitioners of politics and business as well as voters have lost hope for automatic exit from this state of economy. All of the previous Presidency of H. Hoover was held under the slogan of free enterprise as the basis of commitment to the health and strength of the nation, the idea of balancing public finances and general commitment to basic conditions of functioning of the invisible hand of the free market. But the Great Depression demonstrated immense power of “tangible foot" of the market in dramatic shocks in the world economy in the 1930’s. For the whole of the Western world, this event remains one of the greatest social disasters of the 20th century (and perhaps for the United States even much more than the Second World War) and firmly remained in the social memory for decades. On the contrary, the emergence of the acute phase of the economic crisis in the fall of 2008 quickly stopped talking about having to rely on the will of the market, giving quietly dying investment banks, etc. Governments have taken measures to support aggregate demand via fiscal policy tools, have a variety of financial assistance to the largest companies, have taken additional measures on social support of the households; the central banks have met rapidly increased demand of economic agents for money in a rush to the liquidity through the instruments of monetary policy. A special attention was paid to the problems of the stability of the entire financial sector and support of the backbone financial institutions. New principal feature of these actions was their international coordination within the framework of the G-20 in the new interconnected global economy (with the shift in the United States occurred during the Republican administration G. Bush-Junior)[3]. *It should be noted that everybody observed the stylized fact that, in practice, no Government in the Group G-20 relied on the healing powers of free market and allowed to price mechanisms alone to overcome economic recession and restore economic growth.*

The obvious divergence of all practical actions by economic policy makers from mainstream economics, which is repeated for the second time in a situation of serious economic crisis, has raised the question of whether academic economic science within the dominant ideas can perform its practical function. This is the heaviest pull for the resumption of a very deep in essence and this time much less discreet in shape discussions on key methodological and theoretical issues of modern economic science.

1. The world economic crisis and the prevailing ideas of economic theory.

The economic crisis is not a new phenomenon; the crises have been shaking the capitalist market economy throughout its own history since the early 19th century. And, as the patient expects from medical science explanations of ailments and workable recipes to combat various diseases the subjected to socio-economic disorder society expects from the economic science clarification of nature of crisis processes and proposals to counteract them and mitigate their impact.

Of course, such processes have been constantly attracted the attention of economists. Radical critique of capitalist society, from K. Marx to the modern radical economists sees in crisis forms of intractable internal contradictions of the economic system of capitalism, which in principle may not be finally settled under the system. The dominant schools in economics give priority to the totality of certain economic mechanisms that form the economic cycle in the capitalist market economy, and consider the economic crisis (economic recession) as one of the natural phases of cyclical process. However, understanding the nature of this phase and respectively arising from such an understanding best practices for public action (more specifically, the use of instruments of macroeconomic policy and choosing the right combinations of such instruments) differ considerably between the different schools.

Development of world economic thought after the neoclassical revolution in the last third of the 19th century focused on the study (first in statics and comparative statics, then in equilibrium dynamics) of a developed market economy. Theorists have consistently built up models of the the behavior patterns of economic agents at the micro level (firms and households), using as analytical tools of optimization models. The question of how the famous "invisible hand of the market" of A. Smith balances supply and demand in all markets in the economy simultaneously was resolved in in the theory of general economic equilibrium, starting with the works of Léon Walras in the last third of the 19th century and ending with the works of K. Arrow and G. Debrè in the middle of the twentieth century. This theory has demonstrated that the price mechanism under certain conditions leads to vectors of prices and quantities which balance supply and demand in all markets simultaneously. It was given the formal support of some remarkable properties of the equilibrium condition in the form of two welfare theorems, which established a link between the competitive equilibrium in the market economy and Pareto-optimality. It is this range of ideas first strictly formed in mid-20th century became what was called the mainstream economics and formed the basis of the scientific knowledge of the possibilities and limits of price mechanism in the market economy. However, speaking about the findings of economic science on the properties of the market system, most often do not mention that these conclusions are drawn not in general but under certain conditions.

The formal prerequisites of the theory of general economic equilibrium (sometimes combined under the notion of conditions of perfect competition) are well enough developed and known by professional economists; no less extensive is the critical literature that contains numerous critical comments on these assumptions on the part of the various areas of economic thought and other social disciplines [7;8;15;22]. It is clear that within the framework of the theory of general economic equilibrium are omitted altogether social and organizational conditions for the activities of economic agents (which are given, but nowhere are explicitly expressed). The mechanistic picture similar to that of the universe in the Newton's physics draws market economy as a perfect tool for optimal allocation of limited resources to meet the unlimited needs of individuals on the known set of technologies. In such a world, many important aspects of reality just do not have the value and are not subject to the analysis. For example, in the abstract model it's not important how specifically organized economic activity of economic agents at different levels of economic system and they really establish a relationship between them; the market value of the firm is not dependent on the structure of its financing; there are no problems finding information or structuring contractual relationships; it is impossible to explain many phenomena of technical progress; and finally, there is no place here at all to disequilibrium statics and disequilibrium dynamics.

J. M. Keynes in his famous book "The General Theory of Employment, Interest and Money" after the turmoil of the Great Depression proposed a new range of ideas on macroeconomic processes in the market economy and the possible ways of public influence on these processes for the common good. The focus of research was the formation of the aggregate demand in a market economy with particular attention to the investment component, which is dependent on the entrepreneurs' expectations for future earnings. Keynesian macroeconomics has become part of the mainstream economics and actually served as the intellectual basis for macroeconomic policy in developed countries of the West and for development policy in the Third World.

However, the attempt to incorporate the ideas of Keynes in mainstream economic theory was incomplete and contradictory. «Keynesian-Neoclassical Synthesis ", dating back to J. R. Hicks "Mr. Keynes and the Classics», in the end boiled down to the idea that depressive situation as a special case of equilibrium with underemployment, in which case it is possible to use macroeconomic policy tools. At the same time, in the long run all notions of neoclassical economics stand [6]. As for the ideas of J. M. Keynes on the uncertainty in the economy, the formation of expectations in an uncertain situation and phenomena of instability, inherent in the very nature of the capitalist market economy, they for the most part were left out of Orthodox version of the "Keynesian-Neoclassical synthesis" [20].

Neoconservative counter-revolution in 70-80th of the 20th century has led to a significant restructuring of the whole body of macroeconomic theory [17;18]. Every effort was made to banish "Keynesian demon" and come back to the classical postulates of economic theory for the macro level as well. New classical macroeconomics, which occupied a predominant position in the world economic science and macroeconomics curricula in leading world universities, has launched a number of significant new lines of analysis and started the use of a new class of macroeconomic models – models of dynamic stochastic macroeconomic equilibrium (DSGE).

With all the variety of these models it is possible to identify some basic blocks, which can be described as solid core of the research program a la Lakatos. First, a clear description of the microeconomic foundations of macroeconomic processes was introduced. For this purpose the abstraction of a representative agent (a representative household, a representative firm, government) was employed, in which the diversity of economic actors was reduced to a typical micro model. Second, economic behavior was postulated in accordance with the basic principles of neoclassical microeconomics. For formal modeling of this behavior there have been used dynamic optimization models. Third, information imperfections of market economy based on decentralized business processes have been taken into account, but in a very specific manner. Each economic agent has no information concerning the economic system as a whole; he obtains information in the course of ordinary commercial activity, which refers to those activities (output prices, factor prices, public economic information). But in accordance with the basic postulates of neoclassics, he uses all of the information in an optimal way, including making predictions of future events. He can make errors in these projections, but these errors are not systematic. The representative agent has a definite advantage over all real economists and operational forecasters, since his projections is made on the basis of true economic model which he knows! These views developed largely autonomously at the turn of the 50 's-60 's in economic science as the hypothesis of rational expectations and in financial economics as the efficient market hypothesis, have become a significant bloc in this research program on macroeconomics. But are these perceptions essentially different from perfect foresight hypothesis with full knowledge of the entire economic system (although a more complex procedure for receiving and processing all available information is used)? Fourth, all the macroeconomic aggregates in the dynamic analysis originate from the micro-economic optimal decisions of economic agents through aggregation. Fifth, theorists have followed the idea of market equilibrium, which is ensured by the mechanism of flexible prices after any realized shocks.

This theoretical platform was used for the intellectual justification of important provisions about the possibilities of public influence on macroeconomic processes. First, the whole economic cycle was interpreted as strictly equilibrium phenomenon in all phases of which (including recession) market situation is the result of optimal decisions of economic agents in the respective dynamic programs. Second, for the economic system with thus specified properties it was theoretically shown the ineffectiveness of the use of instruments of macroeconomic policy to stabilize the macroeconomic situation at a time when economic agents optimize their behavior in the light of all available information, including information on the economic impact of government regulation (theorem on ineffectiveness of macroeconomic policy).

New classical macroeconomics does not deny the role of public exposure, but had a major revision of its forms. It refocused attention on structural factors – physical and human capital accumulation, maintaining conditions of competition- and institutional factors – the firm adherence to the rules and stable regulations instead of discretionary intervention in economic processes.

New methodological tools became common in macroeconomics and began to be used by representatives of various theoretical schools, including the New Keynesian macroeconomics. New Keynesians have used assumptions of market imperfections in order to justify the short-term government regulation of economic processes. Thus, the new methodology in itself is by no means ceased theoretical debate on the forms and methods of the short-term countercyclical management.

At the same time for fairness, it should be noted that in recent decades has expanded a spectrum of ideas that can be attributed to the mainstream economic theory. On the one hand, the economic practice of a developing market economy demanded answers to questions about what underlies the different organizational structures observed in a real market economy, what the social and institutional conditions of formation of market economy are, and finally, how different organizational structures interact and evolve in real economic activity. In other words, even within mainstream economics the coordination function of economic decisions in a market economy is not reduced to the price mechanism alone.

The study of the above issues has become the research area of the New Institutional Economics. By now this research program as a whole has demonstrated its efficiency, clarifying many important aspects of the social and organizational conditions of formation and functioning of an efficient market economy. Categories «institute», «the institutional process, "" institutional change» have become part of the arsenal of the mainstream economics and influenced the various research programs (including the impact of institutions on economic growth and economic development), a number of theoretical positions received considerable empirical confirmation [e.g. 9].

On the other hand, theorists have opted for the introduction of more realistic assumptions in the model, which allowed them to get interesting insights in the properties of the market process in the presence of market imperfections (such as the existence of monopoly power, the phenomenon of asymmetric information between economic agents, the existence of search costs in the labor market, etc.). Relevant studies paint a far more complex and contradictory picture of market processes as compared with original models of general economic equilibrium, these processes do not always provide Pareto-optimal outcomes. *In such circumstances, the simplicity and unambiguity of theoretically grounded recommendations on economic policy disappears[24;25].*

2. Crisis and critique of economic theory.

So, this divergence in crisis conditions of the key policy practices from mainstream economic theory has raised the question of how modern economics under the prevailing tools of equilibrium analysis is able to carry out its practical function. In the most dramatic and extraordinarily emotional form the main criticisms were formulated by one of the prominent international economists Nobel Laureate Professor Paul Krugman [16]. He noted that established by now the new macroeconomics cannot:

- predict the onset of recessions (they are reduced to unexpected shocks in dynamic stochastic general equilibrium models);
- explain their economic nature (they are reduced to exogenous shocks);
- formulate meaningful recommendations for overcoming them (because the recession is treated as equilibrium phenomenon, where the interests of all economic agents as well balanced, as in any other phase of the economic cycle!).

A separate line of criticism is the fact that modern macroeconomic models ignore the role of the financial sector in a market economy and the characteristics of its own functioning. The financial turmoil has always accompanied the cyclical process of the capitalist market economy, but in the past decade and a half these shocks have become of qualitatively different scale. They have become largely autonomous with significant and rapid impact on real economic processes, rapidly spread between interconnected national economies in the globalizing world economy.

Proponents of the new macroeconomics have made a number of publications in defense of dominant ideas, but all argumentation has remained on the standard line. First, they point out that, in theory, in principle, it is impossible to predict the economic shocks, so this is not possible right now, and it won't be for the foreseeable future [see Robert Lucas in 14]. Second, from an empirical point of view, attempts have been made to associate the recession (at least, in the economy of the United States) with the negative labor supply shock [19]. Third, the problem of instability in the market economy (which in crisis conditions could be hardly ignored) is proposed to be addressed through the choice of stable regulatory norms. Thus Nobel Laureate Professor Edmund Phelps believes that proper state regulation could reduce the costs of instability, including those associated with the phenomena of financial instability (as always the easiest thing remains to be done – to make the right choice of the rules of the regulation!) [21].

3. New macroeconomic ideas for economic policy?

Development of scholarship involves the constructive criticism of existing theories, which goes along with formation and discussion of new ideas. These processes affect macroeconomics during this economic crisis. The participants in the debate also refer to the ideas that have been formulated previously, but largely remain outside the mainstream, having some prospects for further development. What are the ideas that could provide new blocks in the development of macroeconomics?

New Austrians: is macroeconomics useful? It should be noted that the very existence of macroeconomics as a science is not generally recognized in world economic thought. The New Austrian School of political economy (L. von Mises, his most famous disciple Nobel Laureate F. A. von Hayek), based on the principle of methodological individualism, denied the existence of any sustainable patterns of economic system-wide, which could be subjected to rigorous scientific analysis. The theorists in this area put in focus research of individual solutions of autonomous individuals who choose the best means to achieve their goals under decentralized economic processes.

Theorists of the school generally deny the applicability of mathematics and statistics in economic research, because in developing economic systems there are no constants (analogues of physical constants) and homogeneity in any sense (in other words, a physical model of an ideal gas and its statistical apparatus are not proper equivalent to developing economic system).

This position is extreme (though more actively pronounced in crisis situations) and not shared by the majority economists. But it should be noted that modern economics has largely just ignored the above methodological arguments without giving their serious critical analysis and the formulation of clear counter-arguments.

Keynes: uncertainty and expectations. World economic thought revises the theoretical heritage of J. M. Keynes, and primarily, the ideas associated with uncertainty in the economic processes[2]. The economic environment is characterized by a large variety of information imperfections; economic agents do not have and cannot have complete knowledge about the world. They should base their plans and make decisions based on their expectations in an uncertain situation. The problem of stabilization of expectations is closely associated with stabilization of the economic processes in the market economy. But the study of expectations and their formation requires research of bounded rationality and

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[2] In the last three years there was growing number of publications within all Keynesian versions. For an overview see [23].

psychological factors in the behavior of economic agents, explicit incorporation of these aspects in the analysis of real human economic behavior. This way is being attempted to use for a meaningful explanation of the phenomenon of bubbles in commodity and financial markets, and their consequences for macroeconomic processes [1].

Within the above ideas of Keynes special attention is given to a separate question about the instability of the financial sector and the sources of such instability (financial instability hypothesis of Professor H. Minsky). Economists and economic policy makers stubbornly try to formulate such rules of regulation, which would guarantee the stability of the financial sector in general and the banking system in particular with regard to financial laws of market economy [10;28].

Schumpeter: entrepreneurship, economic development. Another range of ideas is linked to the fact that a developed market economy, by its very nature, is dynamic, non-equilibrium, developing system. It constantly introduces new communication, relationships, formal and informal rules, new products and services, and new processes, new organizational structures are formed. It is clear that at any given moment of time economic agents cannot possess not only all information on current developments in the economic system, but they cannot know the future scientific, technical or social knowledge, because this knowledge will be recognized only in the future in the course of practical activities in the context of decentralized economic processes. An attempt to understand the processes of economic development returns to the ideas of J.-A. von Schumpeter, which have been formulated in the first third of the 20th century. These ideas are a starting point for the development of the evolutionary economics and consequent formal evolutionary modeling of macroeconomic processes [5].

Economy: the network of participants. Finally, an important aspect of independent functioning and development of the economic system is the process of forming connections between economic agents and the properties of this process. The economy may be thought of as a network of participants that establish relationships and interact through market exchanges (economic theory of networks), this networks can be formed in different ways and provide the various outcomes at the macro level. It is this aspect which is brought to the forefront in "Kiel Memorandum", which calls for a review of not only the theoretical notions about market processes, but also for use of different mathematical tools in economic research [11].

4. Some preliminary conclusions.

These ideas have not yet formed any holistic picture, but they have attracted the attention of researchers in terms of future perspective. It becomes clear that mechanistic picture of a market economy, which is derived from the theory of general economic equilibrium and the modern dynamic models of general macroeconomic equilibrium (DSGE), can hardly be the intellectual foundation of sound economic policies. In general it can be said that macroeconomics is still a large field of theoretical and methodological debates, and the crisis significantly upped their intensity compared to the previous twenty years. It should be stressed once again that the current state of macroeconomic theory does not justify any sound recommendations for macroeconomic policies without taking into account the specific economic conditions. Any particular mechanism of coordination and control – the price mechanism, hierarchy, intermediate forms – is exposed to numerous imperfections, having both strengths and weaknesses. Any attempt to establish a fixed set of recipes (as, for example, formulated at the turn of the 80-90's list of recommendations the Washington Consensus) will be in general practically counterproductive.

Neither very clear is the perspective of finding non-discretionary rules of regulation, which would counteract the phenomena of instability in developing socio-economic system. Apparently, in the face of increasing scale, scope and intensity of economic and social relations (this phenomenon in Marxist theory is characterized as the socialization of labor and production) inevitably raises the issue of combination of decentralized economic processes, inevitably associated with uncertainty and consequent incorrect expectations, with public institutions and mechanisms of regulation, control and monitoring. But their particular mix is a matter of the circumstances of time and place. Alas, Mankind has not yet found the Philosophical Stone, and, accordingly, the cure for all diseases and universal economic policies as its specific forms…

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