EKONOMIA ECONOMICS 2(14) • 2011

ISSN 2080-5977

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LESSONS OF THE GREAT RECESSION FOR THE GLOBAL ECONOMY AND CEE COUNTRIES

Summary: The scope and severity of recent financial crisis (dubbed "Great Recession") could only be compared with the Great Depression of the 1930s. Yet, it is still not obvious whether recent financial and economic turmoil will prompt the same breakthrough in the discipline (triumph of Keynesian economics) and practice (New Deal). Before an implementation of any sensible reform one needs to learn the origins of the crisis. As they are most likely structural (inadequate institutions and growing income inequality, etc.), the article argues that there is a need for a paradigm shift in development theory and practice.

Keywords: Great Recession, financial crisis, global imbalances, neoliberalism.

1. Introduction

The unprecedented scale of the recent global financial crisis was a big shock not only for policymakers, but also for economists. Yet, it would be an exaggeration to say that nobody expected the looming crisis. A number of studies were published before the crisis arguing that the current model of economic growth was unsustainable. Undoubtedly, one of the most comprehensive and important book on this subject is *A Brief History Neoliberalism* by D. Harvey published in 2005. It is worth mentioning some other imminent economists such as J. Stiglitz, P. Krugman, A. Sen, N. Roubini, the Polish economist G.W. Kołodko and even J. Sachs, who called into question the neoliberal economic doctrine or current globalization long before the Great Recession. Some statements made by these economists were standing in stark contrast to mainstream views on economic doctrine or policy: "I was at the World Bank, I saw firsthand the devastating effect that globalization can have on developing countries, and especially the poor within those countries" [Stiglitz 2003, p. IX]. However, these descriptions dealt with third world and developing countries. It is hard to imagine a broad reform (not to mention a collapse) of neoliberal economic model resulting from such "small" deficiencies or frictions[1].

[1] The word *friction* was often used in the rhetoric of mainstream economics. Yet, its citation number in working papers has greatly diminished.

2. Origins of the Great Recession

The recent crisis, in contrast with the previous ones, clearly demonstrated an intrinsic weakness of many advanced economies (and their model of growth). Markets are not subject to mere frictions – economy could be in the state of long-term imbalance or multiple equilibra are possible. Hence, a debate was prompted on the viability of economic policy and economics itself. Such a debate is indispensable especially in CEE countries, which are still in the process of transformation after the fall of eastern bloc[2].

In the case of Poland, the discussion on the possible adjustments of neoliberal doctrine was very much subdued. Calling into question recent growth model was like advocating socialism. Those supporting the idea of so-called "third way" were at best treated as dreamers or utopists. Neoliberal attitudes were imported to Poland from Anglo-Saxon countries[3]. According to English scholars, the biggest victory of Margaret Thatcher was the changing of language (used both in everyday conversations and in the mass media). Interesting insights into the subject were provided by English marketing expert Peter York in an interview on the BBC. In 1970s language of marketing was a minority language. It was treated with contempt by educated people. In the 1980s, however, everything changed. According to P. York "in 1980s in Britain marketing people took a leading role in Margaret Thatcher's new world (…) In such a world everything is a market and everybody is a consumer"[4]. It is hard to object to the statement that "the rise of marketing and particularly the language of marketing changed the way we speak and think about the world" [York 2010]. This new world, according to the new neoliberal doctrine, is supposed to be a collection of egoistic individuals concentrated on work and consumption. M. Thatcher's famous observation that "there is no such thing as society" [Steele 2009], though taken out of broader context, seems to perfectly describe conservative government's intentions towards organizations like trade unions. Indeed, trade unions and strong ties between people were perceived as a hindrance to new world and new society. That is the reason why the British government put a lot of effort to crush the big miners' strike which began in March 1984.

The same zeal to marginalize trade and labour unions, and state-owned co-operative farms has started to dominate among Polish policymakers and economist since the early 1990s (hence about the decade later than in England). It is a paradox that it took only a couple of years for the new elite to completely change the attitude towards such unions in Poland. In the 1980s (especially during the martial law)

[2] They are all classified as emerging markets with the exception of Slovenia and, in most cases, the Czech Republic.

[3] In fact, this was a global tendency that started in late 1980s. The fall of military rule in many regions (including Latin America) enabled fast market oriented reforms – the process known as free market triumphalism.

[4] More on this subject in Wątroba [2009].

thousands of people (including many pro-democratic intellectuals) went on strike, suffered persecution, and even sacrificed their lives (like priest J. Popiełuszko) in their fight for freedom and free trade unions like "Solidarity". It is worth stressing that famous 21 postulates of shipyard workers in Gdańsk included the existence of free labour unions, the right to strike, and the safety of those on strike[5]. Somehow, after the collapse of the system, the new democratic administrations ostentatiously showed great disrespect to such labour organizations. Newly established followers of neoliberal doctrine did not need any feedback from the society. The pluralism of ideas was no longer necessary. Policymakers knew better how to create a new world[6]. The opening to the west started an excessive and sometimes thoughtless import of not only goods, but also English language as the modern medium of communication [Śliwa 2010] and neoliberal ideology.

The same mechanism worked in the current crisis as its roots are dating back to the end of 1970s or 1980s, when M. Thatcher and R. Regan came to power. The socio-economic debate was greatly reduced. In fact there was no need for any disputes in the light of the buzzwords prevalent in the past 20 years [Kołodko 2008, pp. 29-30]:

– TINA (There Is No Alternative),
– end of history (by Fukuyama).

Indeed to make the economy even more vibrant, some adjustments were necessary, thus the list could be extended by:

– innovate or die;
– shock therapy (used in Poland);[7]
– privatise, privatise, privatise (recipe for success in Russia advocated by M. Fiedman;[8]
– flat tax.

It is interesting to note that practically every three or four years Polish citizens were acquainted with a new model country that was supposed to be imitated in order to speed up economic growth. It is worth enumerating some of these model countries and provide explanations why they won so much praise from the mainstream economists and the mass media in Poland (roughly in chronological order):

– Japan: Poland was supposed to be the second Japan – fast growth and efficient management style, co-operation, productivity, and innovation were admired;
– USA (American dream): dynamism, low unemployment, deregulation, low taxes;

[5] www.solidarnosc.org.pl/pl/21-postulatow-1.html.

[6] New ideology was sold almost like a product (marketing via the mass media). The competitive visions of a country and its development were strongly attacked.

[7] Polish economists are still deeply divided on this issue. G.W. Kołodko described it as "a shock without therapy". More detailed analysis of this subject in Orłowski [2010].

[8] Shortly before his passing, M. Friedman in an interview acknowledged that he was wrong on this and Joe (Joseph Stiglitz) was right.

- The Netherlands: low unemployment, consensus between employers and trade unions, employees refrain from demanding higher wages;
- Spain: the role model for Poland, fast developing country thanks to the accession to the European Community, proper utilization of EU funds, spent on new motorways, the substantial reduction of unemployment rate;
- Portugal (often contrasted with Greece that was presented as a laggard): the proper utilization of EU funds, dynamic growth, the host of European Championships in football – the indicator of economic success and improvement in infrastructure;
- Baltic States (Latvia, Lithuania, and Estonia): slashing taxes, introduction of flat taxes, which according to mainstream economists greatly enhanced GDP growth to 8-9%, dynamism, high FDI, low unemployment, orientation on export, fixed exchange with euro, the advocates of fast entrance to EMU, good fiscal situation (very low public debt[9]);
- Ireland: green island portrayed as a paradise land, Poland was supposed to be a second Ireland[10] thanks to lowering taxes, introduction of flat tax, dynamism and strong growth of FDI, multinational-friendly thanks to low taxes, especially CIT);

This neoliberal message was conveyed via the mass media by influential commentators and economists, etc. Interestingly, almost all listed countries suffered severe economic problems shortly after they were presented as role models. Therefore, it could be concluded that there was a lack of proper understanding of global long-term socio-economic trends. Poland was swimming with the tide rather than trying to initiate a debate on broader development goals and necessary reforms[11]. It proves that our long-term economic policy was incoherent, chaotic, or even nonexistent[12]. E. Mączyńska came to the similar conclusion and provided some explanations: "at present practically there is no central institution dealing with quantitative and qualitative regularities and trends in both economic and world transformations" [Mączyńska 2009a]. As she notes two institutions that previously dealt with such problems were shut down. Rada Strategii Społeczno-Gospodarczej przy Radzie Ministrów operated since June 1994 until 3 March 2006, while on 17 February 2006 the Polish Parliament enacted a bill that resolved Rządowe Centrum Studiów Strategicznych (Government Centre for Strategic Studies). These actions resulted in centralized expertise and a lack of broader perspective and feedback from scholars from various academic centres. Therefore, Polish strategic planning institutions fell victim to

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9 An upbeat assessment of the Baltic States' fiscal policies was delivered by Rzońca [2007].

10 This rhetoric was extensively used before the election to the Polish Parliament in 2008.

11 Certainly Poland was not an exception.

12 M. Król [2005] argues that it is typical of neoliberals to focus mainly on the present as they often skip the analysis of economic history and even wary of planning as they link it with government interventionism.

these unfortunate decisions. Indeed, it is hard to imagine the US president without the Council of Economic Advisers.

The erosion of government and independent expertise was a widespread phenomenon especially in recent twenty years. In developed countries, for example, private think tanks financed by various pressure groups have been gaining strength. There were also big problems with credit rating agencies. Their expertise was sometimes seriously flawed prior to the Great Recession (mainly because of inadequate incentives).

Hence, the privatization of institutions does not solve problems with asymmetric information. Moreover, markets require proper controlling institutions that can only be provided by government.

Up to now, the growth rested on continuous bubbles created in the stock exchange (IT bubble that burst in 2000-2001) and recent more serious one which inflated in various markets (mainly in various financial markets and construction sector). Speculation was possible because of deregulation (advocated by neoliberal economists and stakeholders) and the lack of proper supervision. Neoliberal doctrine proved to be inadequate and very dangerous for both developing and emerging markets much earlier. The massive deficiencies of the system came into light with the series of crises in Mexico (tequila crisis), Brazil, Asia, Russia, and Argentina. In all these countries, neoliberal doctrine led to unbalanced growth and rising income disparities (Argentina is a perfect example of these faults) [Szydło 2010].

A growing gap between the rich and the poor [Brzeziński 2010; Harvey 2005; Hsing 2005; Pressacco, Seravalli 2009] and the erosion of the middle class prompted the so-called "savings glut". It needs to be emphasized that savings glut was one of the main factors that prompted the speculative bubbles, which translated into global economic crisis. The companies both from advanced and developed countries were awashed with cash[13] (which further lowered interest rates), while American or Anglo-Saxon consumerism could develop thanks to low credit costs (at least initially), the rapid development of credit card market (in 2008 an average American owned thirteen credit cards) [Zakaria 2008] and US administration policies promoting purchases of new houses (not only via Freddie May and Fennie Mac, but also private institutions). Theses imbalances could not exist separately. The profits made during the boom were channeled into the housing market, creating the gigantic bubble. In the case of America, it was propelled by the so-called "Ninja" and "Alt A" credit offered to sub-prime borrowers, while in tourist countries (like Spain) there was a boom in luxurious apartments built around the coastline. Construction companies, owned by Spanish millionaires (like the president of Real Madrid football club) and foreigners, greatly capitalized on this boom. The offer of new apartments and villas in the case

[13] Even in recent years (2010-2011) companies in a number of countries (including Poland) have been accumulating cash. One possible explanation of this phenomenon is that too much tax burden is resting on lower and middle class.

of Spain was aimed at upper-middle and especially higher class from various countries that also disproportionately profited during the boom years. Luxurious villas and apartments (often with access to new golf courses) were treated as a safe and profitable investment. The resulting imbalance ended in the vast oversupply of residential buildings and the creation of so-called "ghost towns" (striking examples of which could be found in some neighbourhoods in the US, Spain,[14] and Ireland).

3. Lessons from the Great Recession

In the light of this discussion, a simple but possibly the most important conclusion can be drawn that many breakthroughs in science and possibly other fields would not be possible without questioning *status quo*. The development of any science requires pluralism and the competition of ideas. These are especially vital for social sciences.

In this context, it is also important to stress that economics is a social science and cannot be confined into mere exercise in advanced mathematics. As Global Recession proved many sophisticated economic models were seriously flawed. They could not predict the crisis as they were unable to assess the systemic risk and human factor. To paraphrase John Paul II, economics needs two wings so there is a place for both mathematical and socio-economical studies. Some progress has already been made with the development of behavioral economics. However, according to A. Wojtyna economics is rapidly expanding into other fields [Wojtyna 2008]. This expansion is often connected with the transmission of economic method which requires building models. As it was already stated, this scientific method has serious deficiencies. More and more economists are calling for interdisciplinary studies which are more suitable to describe and explain the complexities of globalized economy [Kołodko 2008, 2010; Mączyńska 2009b]. Other scholars are advocating doing research in economic history. They claim that a proper analysis and understanding of past crises would substantially diminish the likelihood of any future financial turmoil. Indeed, these two methodological proposals should be more widely used by economists.

But there is still a big gap between the so-called "salt water" and "fresh water" economists (the division proposed by P. Krugman). It seems that the latter (the advocates of neoliberalism mainly from the University of Chicago and partly from Harvard – the university of American political and financial elite) will stick to their doctrine despite all the recent unfavourable developments. Neoliberal economists put all the blame for the crisis on inadequate government policy (the promotion of home purchases in the US) and on A. Greenspan (once praised as the best central banker) for keeping interest rates too low [Taylor 2009]. In the heat of the debate, causes are mixed with consequences (i.e. the installation of nominal public debt counter in Warsaw). It remains to be seen whether more socially oriented and heterodox salt

[14] Some lessons have been learned from recent crisis in Spain, see [*Polska 2030*… 2009, p. 23].

water economists from coastal universities would be strong enough to change both discipline and economic practice. Recent developments are not optimistic.

Up to now, relatively little has been done in the sphere of economic policy and global rebalancing. Central banks started to use heterodox policies (quantitative easing) and governments returned to Keynesian type policies, yet it seems that the economic system needs deeper, structural reforms. New financial and economic architecture would require serious reforms of major institutions (especially central banks and stock exchanges) both in advanced and developing countries. Undoubtedly, there is a need for balanced development not limited to GDP growth. Government co-ordination is also needed in social policy to tackle growing income inequalities as productivity growth far outpaces hourly wage growth in the US and other countries.

This brief analysis allows formulating several conclusions and lessons for economists and economic policymakers:

1) Neoliberal paradigm was totally discredited by the Great Recession – the biggest crises since the Great Depression.

2) World economy is interdependent and requires global co-ordination that would prevent or at least adequately deal with global imbalances.

3) Economic paradigm shift is required – the current model of growth resting on the speculations on various markets is not sustainable; consequently, neoliberal doctrine should be replaced by the doctrine of sustainable development focusing on balanced development of three main spheres – economic, social, and environmental.

4) Both internal and external rebalancing is necessary. In the first case the fruits of growth should be more evenly spread between all the citizens of a country in line with productivity gains. In the second, gradual rebalancing is required between current account deficit countries (mainly the USA, the UK) and surplus countries, i.e. China, Japan, Germany, and oil exporting nations.

5) The costs of property bubbles are much higher than IT bubbles and require lengthy adjustment process – the depreciation of housing is much longer than computer hardware and software. It is one of the reasons why it took Japan so long to recover from the crisis that started at the beginning of 1990s after the bursting of the housing bubble. Hence, special attention ought to be paid to the extraordinary movements of housing prices. The adequate regulation of mortgages is required, promoting stability and transparency as house purchases are the most important economic decisions conducted by individuals[15].

6) The invention of new economic instruments – similarly to the discoveries in physics (nuclear energy) and biology (genetic modification) could yield both positive and disastrous consequences. Without doubt, more control is needed in this respect. Precautionary principle should be obeyed.

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[15] Some initial attempts to better regulate the mortgage market have already been made by the EU.

7) Too big to fail problem should be adequately tackled[16]. The separation of investment banks from retail banks seems to be indispensable (a bank as an intermediator not an investor or speculator).

8) The costs of crises resulting from the speculative bubbles on various markets should be evenly carried by those involved in the contract (both borrowers and creditors). Shifting this burden on taxpayers via the increase of regressive indirect taxes (as it was the case in many countries, for example Poland and Great Britain) starkly contradicts not only with polluter pays principle (formulated by sustainable development theory) but also Schumpeter's creative destruction theory (according to which weak and badly managed institutions are replaced by new more innovative and adaptable ones).

9) Broader socio-economic analysis is indispensable to adequately assess the state of a country (e.g. low public debt can easily balloon to unprecedented levels as in Ireland and Baltic States).

Major reforms of fiscal policy are also indispensable. These should include:

– the abolition or at least the reduction of safe and tax havens,
– the co-ordination of tax policy to limit tax competition (race to the bottom especially in developing countries – including CEE countries);
– the reduction of indirect taxation (VAT and excise duty), which could be offset by higher taxes on big companies,[17] including multinationals (progressive CIT), higher receipts from more progressive PIT,
– the implementation of global Tobin tax[18] (tax on capital flows).

These fiscal reforms would substantially reduce savings glut, which was created mainly by companies. Other reforms, relatively easy to implement, should be employed, i.e. rising inflation targets as put forward by O. Blanchard. It is a sensible proposal for both developed and emerging economies. Slightly higher inflation rate requires higher nominal interest rates. Consequently, there is more room for the maneuver for policymakers (Monetary Policy Committee) as deeper interest rates cuts are possible in the case of financial turmoil (liquidity problems) and recession.

It seems that the treasury could also benefit from this arrangement as money illusion allows the faster and smoother adjustment of real wages without serious repercussions on the labour market (there is no need for nominal wage cuts[19]). Most likely

[16] According to K. Pietraszkiewicz, the EU is currently working on the matter.

[17] Already implemented in Hungary. Some mainstream newspapers in Poland fiercely attacked this reform.

[18] A preliminary proposal was put forward by the EU to implement a financial transaction tax. According to "Parkiet" revenues are supposed to amount to 50bn EUR. Quotas are likely to range between 0.01% and 0.1% depending on the type of instrument. According to A. Słojewska, neither the US nor Asia are interested in implementing the same type of tax. As a consequence, investors could abandon the EU and move to untaxed countries.

[19] Yet, in some countries (e.g. Greece, Baltic States, Portugal) deep cuts of nominal wages were executed. It shows the unprecedented scale of recent recession.

governments would also use inflation to improve fiscal position[20]. The overshoot of inflation leads to the increase of tax revenues (i.e. VAT and income taxes). It is worth noting that all these advantages of unexpected inflation only temporarily provide a breathing space for policymakers. Hence, structural reforms are indispensable.

Another important lesson from the crisis is that it would take much more time to resolve this imbalance as compared to previous dot-com bubble. First, the scale of the recent crisis is much greater – the recent bubble dwarfed the previous one in terms of amount and scope encompassing the majority of developed countries. Second, as it was stated, the depreciation of housing is much longer than computer hardware and software[21].

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[20] Some governments may already use this arrangement.

[21] It is estimated that in the US housing depreciates at approximately 2 percent per year.

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LEKCJE WIELKIEJ RECESJI DLA GOSPODARKI ŚWIATOWEJ I KRAJÓW EUROPY ŚRODKOWO-WSCHODNIEJ

Streszczenie: Głębokość i skalę globalnego kryzysu finansowego (określanego w literaturze przedmiotu jako Wielka Recesja – *the Great Recession*) można porównać jedynie z Wielkim Kryzysem z lat 30. ubiegłego stulecia. Mimo to w dalszym ciągu nie jest pewne, czy kryzys będzie katalizatorem przełomu porównywalnego z tym, który nastąpił w ekonomii (triumf ekonomii keynesowskiej) oraz polityce gospodarczej (*New Deal*) ponad 70 lat temu. Wdrożenie odpowiedniej reformy wymaga poznania przyczyn ostatniego kryzysu. Jako że mają one charakter strukturalny (nieodpowiednie instytucje oraz rosnące dysproporcje dochodowe) konieczna jest zmiana paradygmatu ekonomii rozwoju oraz praktyki gospodarczej.