

CHALLENGES OF GLOBALIZATION

**THE GLOBAL ECONOMIC RECESSION
AND THE CHANGE IN THE
MACROECONOMIC PARADIGM**

DRAGAN MIHAJLOVIC,
SUZANA ZIVKOVIC

Faculty of Management, Zajecar,
Megatrend University, Serbia

JEL Classifications: B22, E12, F02

Key words: Recession, stagnation, economic policy measures, macroeconomic paradigm, Keynesian economic theory.

Abstract: All countries have felt the impact of the recession, the phase characteristic of negative effects such as slower economic growths (stagnation), high inflation rates and high unemployment rates. The economic crisis that has befallen even the most developed economies of the world is often compared to the crisis that happened in the 1930s, along with the attempts to pin down its causes in order to find the economic policy for its overcoming. Economic policy creators and policy decision-makers have to solve the question of how the crisis is to be overcome. Economic measures that should lead to overcoming the negative economic trends are primarily directed at encouraging aggregate supply, that is, a macroeconomic theory known as Keynesian economics based on the ideas of 20th century British economist John Maynard Keynes that he published during the Depression. Up to this day economies have not faced such a downfall as happened during this crisis, since the crisis brought about not only changes in the economic theory and the end of the so-called classic economic theories, but it also made way for a new scientific discipline based on Keynesian theory. There were changes in economic policies and an active policy of managing aggregate supply was introduced. Aggregate supply was based on monetary and fiscal expansion, that is, the world monetary and financial system. It is expected today that the crisis we are now facing will lead to the change in the dominant macroeconomic paradigm as well as to the creation of a new financial system which will be more transparent and regular.

ISSN: 1804-0527 (online) 1804-0519 (print)

Vol.7(1), PP. 5-7

Introduction

After many decades of economic growing, the global economic recession came as a big surprise and had as a result a number of changes in the economic policy, that were applied in the Great Economic Crisis, that is, the changes defined as the counter-cyclical economic policy. The dominant opinion of macroeconomists according to which the neo-liberal concept has faced a collapse, is now seen as too early stated, and even wrong. Regardless of the dominant macroeconomic theory on which the economic policy relies, there are two different lines of research: neoclassical and Keynesian. The development of macroeconomics so far has been a product of a dynamic interactive process between external causes and internal sources. And when the issue is which one of the two programs is more dominant, a number of factors are to be considered such as economic, social and political.

The economic recession and measures of economic policy

The aim of a decade-long development of the macroeconomic theory based on macroeconomic bases and economic policies has been the macroeconomic stability - price stability, and it depends on rational expectations of economic actors as well as on the influence exerted by the economic policy on the real economic activity which is not possible either in long-term or in short-term period. The development of macroeconomics and the new ways of doing things in this sphere in the last decades has led to the development of

political macroeconomics which deals with how politically motivated decisions influence, or even abuse, the economic policy. The aim is to make such behaviour impossible. Macroeconomics has developed an idea which is related to the following: which institutions are influential in the macroeconomic policy and which are not.

Such a development of macroeconomics, based on the market and the institutional development with the aim of preventing any kind of abuse of the economic policy and state intervention, has been encouraged by real economic trends. These trends show that today's cyclical fluctuations are not as intensive or lengthy as those from the 1980s and particularly those which existed before the Second World War. The data on cyclical trends in the developed countries speak in favour of the longer expansion phase and the shorter contraction phase. In the USA, the expansion phase is now 57 months while it lasted 25 months before the Second World War; the contraction phase is now 10, although it was 23 months before the War. The longer expansion phase and the shorter contraction phase are even more obvious if we look at the last two business cycles in the USA - from November 1982 to March 1991, and from March 1991 to November 2001. The expansion phase lasted 120 months in the USA; while the contraction phase was only 8 months. The almighty global market and its mechanisms have led many countries to adopt the principles of the market economy. Yet another proof of superiority was precisely the triumph of capitalism over the centralistic system which existed in the state-controlled markets.

These were the circumstances in which the global economic crisis took place. It started with the negative economic trends in the USA in 2007. The first indicators of a possible future recession the USA made the creators of the economic policy change the way it had been led. The first reaction came from the Federal Reserves that tried to lower the interest rate and thus affect economic activities, but all economic trends showed that the situation had only been worsened. In other words, the Keynesian theory was proved - the paradigm referring to the inefficiency of monetary policy by decreasing the interest rate in the struggle against recession. The expansive monetary policy was followed by fiscal expansion seen in several economic programs undertaken by the President of the USA; these programs were aimed at decreasing taxes, which on one hand would increase salaries and people would have more money to spend and on the other, new investments in equipment and capacities would be made. These economic measures only had limited results and in the fall of 2008 the USA faced another crisis when it became clear that it was the global crisis of the scope and range that could only be compared to that which happened in the 1930s.

The Keynesian paradigm - the theory which is now in trend

The economic trends, as well as the changes taking place in the economic policy, impose the following problem: will the applied measures of the economic policy help the main principle on which the market system relies? The main principle is maximizing profits, that is, making a profit by help of economic actors guided by an "invisible market hand". In other words, the main economic motive - profit - which inevitably leads to greed is the main cause and reason of the current economic crisis; this is especially true of the countries which lack regulations and standards, primarily the consistent financial system.

The crisis has not reached its peak yet, and that is why we still cannot talk about a new macroeconomic theory developed for its solving. The measures used in most countries may lead us to the conclusion that the neo-liberal doctrine in economics has collapsed, and since this doctrine has been used as the main one in economic policies, we can also conclude that state intervention measures are almost inevitable. The Keynesian paradigm - theory which is again in the centre of attention, brings into question the perfect functioning of market mechanisms, or more precisely, the uncertainty of market automatism.

Today, creators of economic policies tend to avoid making the mistake made in the 1930s and that is the reason why they have taken the necessary measures to encourage the aggregate demand, and this is done using all three of its components: investments, government expenditures and personal spending; this is done primarily because of the main macroeconomic problem, and that is unemployment or poverty. The success of the economic struggle depends on the success of saving the so-called "middle class", but also on psychological factors which have proved to be the most dominant ones in the period of economic crises. The question is how to change the expectations of consumers and other economic participants when there is an economic crisis and when the economic system of the country is becoming weaker and weaker.

The economic measures which are to get primary role are those that affect how much the population spends, because spending is the most important component of aggregate demand and revenues. In the developed countries, spending makes between one half and two thirds of the overall aggregate demand. The data on the US economy show that spending absorbs between 60-65% of the GDP; even more than 90% of salaries goes on spending, and there is a permanent growth of salaries in the GDP. As far as accounting is in question, there are three components: 1) spending non-durable goods, 2) spending durable goods, 3) services. Due to this, spending has many effects on how aggregate demand changes.¹ Different components react differently during the cycle, and spending durable goods considerably affects the cycle (it is possible to postpone buying the goods) as the cycle amplitude showing the spending of such goods oscillates very much: it increases by 31% and decreases by 27%.² This is the very reason why certain industries which produce such goods are especially vulnerable during the cycle, such as automobile or electrical industry. They employ a large number of people who are at risk of losing their jobs in the face of the economic crisis. We should also emphasize here the decline the construction business faces in the recession, which is especially important in the current economic crisis, just as we should not neglect the collapse of the mortgage market which took place in the USA in 2006.

Analyzing the monetary policy of the USA in 2000, one question imposes itself and that is whether monetary authorities could have anticipated such decline in the economic activities, or whether the expansive policy should have been engaged earlier, that is before September 2007 when the interest rate decreased from 5.25% to 4.75%. There is also the fact that the economy of the USA employed almost all capacities and unemployment was very low (the unemployment rate was 4.5% in May 2007, which is below the natural unemployment rate).

The monetary authorities feared that the economic expansion might lead to inflation and were very careful when lowering the interest rate. More drastic drops in interest rates began only in January 2008, when the economy was already caught by the recession, and the interest rate dropped from 4.25% to 3.5%. The interest rate of 4.5% is considered neutral and does not affect economic activities. The fiscal expansion is a well-known counter-cyclical tool and is used when there is a need to lower taxes both in economy and among the population; its aim is offering tax benefits for investing in new technologies and capacities (developing production investments), that is, increasing spending on the part of the households as they would have higher salaries.

These were the key elements of the package offered by President Bush by help of which he tried to motivate the economy of the USA at the beginning of 2008. It was estimated to be worth about USD 152bn, and had certain effects on the economy but not strong enough to recover it during the summer of 2008.

¹ For example, 1% decrease in personal spending in the above mentioned year in the USA actually means decrease in aggregate demand of more than USD 40bn.

² The data refer to the economy of the USA.

Coordinating the monetary and fiscal policies

In order to accomplish the main objectives of the macroeconomic policy (full employment of all production factors, stable prices, optimal and balanced economic growth and balance of payment) today's governments employ both monetary and fiscal measures. These measures are the key factors which contribute to the economic development in the sense that economic upturns and fluctuations are to be avoided and permanent growth and development of the economic system ensured.

Using the available monetary and fiscal measures, the government achieves certain effects and goals in the control of the global demand. Here, the main rule is that public financial activities have to be harmonized and coordinated (these are activities in the field of monetary and credit structures, tax system and spending of public expenditures). In other words, all these measures and activities have to be undertaken in such a way as to help accomplishing the objectives of the economic policy. However, the fiscal and monetary-and-credit policy can be alternatively used, but as a rule, the monetary and fiscal policies are harmonized because that is the only way they can give positive results, that is, economic goals are reached within a given time limit. Since the government has a powerful effect on the overall demand through its budget (taxes and public revenues), and monetary and credit measures, the main and dominating goal of harmonized fiscal and monetary policies is having adequate effects on the global demand. At the same time, the tools and effects in the domains of public financial activities have to be coordinated and employed to contribute to the sustainable growth and stability of the economic system as a whole. In some situations, fiscal measures alone are enough for reaching stabilization, which depends on how much the economy is disturbed or sensitive to certain measures of the financial policy. When the economic situation is different, the alternative measures of monetary and credit policy will be required. As a rule, the fiscal and monetary policies have to be in harmony and used at the same time equally in order to accomplish the economic goals in the given period of economic and overall social development of a country.

Conclusion

What inevitably characterizes market economies are cyclical fluctuations (upturns). In the period of expansion this is not so obvious, unless in the situations when policy makers get afraid that the situation will become 'overheated' and try to employ the measures to prevent this. The economic crisis which sprang up in the USA and befell the majority of the developed countries, brought back the application of counter-cyclical measures in the economic policy and instead of free market and automatic market mechanisms, state interventions are necessary to 'save' some economic entities and financial institutions. All this has certainly led to the changes in the dominant macroeconomic paradigm.

References

- Alesina, A., Perotti, R., 1995. "The political economy of budget deficits," IMF Staff Papers, Vol.42, pp.1-31.
- Alesina, A., Roubini, N., Cohen, G., 1997. Political cycles and the macroeconomy, MIT Press, Cambridge, Mass.
- Prascevic, A., 2008. "The return to Keynesianism in overcoming cyclical fluctuations," Economic Annals.
- Stern, N., 1984. Modern tax theory for developing countries, The World Bank, Washington,
- Tanzi, V., 1992. Fiscal policies in economies in transition, IMF, Washington,
- Taylor, P., 1953. The economic of public finance, New York,