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THE FIRST GLOBAL FINANCIAL CRISIS IN THE 21ST CENTURY

REASONS AND CONSEQUENCES

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Economists use diverse expressions for describing economic problems: retardation, stagnancy, stagflation, recession, depression. However, the best-known expression is *crisis* that appears along with diverse prefixes facilitating understanding: global, financial, debt, structural, cyclic, development, etc.

Under particularly difficult circumstances we use expressions of economic *chaos* and *crash*.

During these past two years Nobel Prize winner economist Paul Krugman used expressions having stronger effect on collective sense like economic *catastrophe* and *pit* (as well as *submergence* or *inferno*).

Each and every expression can be described by different normative and theoretical definition. Unfortunately these are not differentiated perfectly even by professionals, inducing semantical, theoretical and political disputes again and again.

The global financial crisis we still can feel these days started in 2007 by the first ‘bubbles’ appearing in the real estate market in the United States (touching construction and automotive industry after reaching financial and banking sector as well). The crisis reached Europe by the debt crisis that became dramatic by 2010 and was triggered by the economic crash of the PIIGS (Portugal, Ireland, Iceland, Greece and Spain). Moreover, the European Economic and Monetary Union had lurched as well.

These factors brought not only the usual problems in case of any similar crisis (growing unemployment, shrinking GDP, drop of production, loosing economic trust, general uncertainty and appearance of fear of future) but they also revived theoretical, political and cultural battles between free market followers and interventionists.

Neither the best economists of the world nor the most successful entrepreneurs and traders or futureologists are able to estimate how long the crisis will take and what its after-effects will be. Similarly, the battle between the economic doctrines representing diverse views does not shrink either.

This study tries to map the effects of global, European and Croatian economic crisis on economics, economic philosophy and each and every level of macroeconomics.

Key expressions: global financial crisis, recession, subprime loans, conceptual and discursive shocks, economic philosophy, trust, corporate social responsibility, state intervention, regional economy.

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The global financial crisis that started in the US in 2007 brought primarily typical economic problems similarly to other crisis: raising unemployment, drop of GDP, crisis of economic trust and appearance of general mistrust and fear of future. In addition, new problems appeared like political and cultural battles between followers of free market and interventionists[1] in the modern world as well as disputes between followers of CSR[2] however in a significantly lower rate.

Nevertheless, we must know that today even the best and most influential economists[3], the most successful entrepreneurs or the most prominent statesmen and futurologists are not able to give solid estimate

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[1] Institutional framework of state intervention in open social economies and global economies is much more restricted
[2] Corporate Social Responsability
[3] The expression of ‘best economists’ is to be considered as conditional. Here we mean scientists most often cited in theoretical, political and public discussions about global financial crisis. For measurement and ranking there are many

of measure, nature and content of economic and financial convulsion that the US faced in 2007, and that other national, regional economies in 2008-2009 and later the whole global economy also experienced.

It is even more difficult to guess what kind of consequences it will have on economic philosophy, economic paradigms and economics, social institutions, macroeconomic practices and theories, microeconomic policy and international relations on global, European, Croatian and local level.

However, it is easily noticeable that values of economic analysts and forecasting agents are changing. The day before we could see combat of scientists and politicians on economic and macroeconomic optimism, today most of them are showing up with pessimistic and apocalyptic scenarios.

At the beginning of 2009 when the 'package to boost economy'[4] of Barack Obama was passed, we could experience some particularly intense theoretical disputes about the strategy of coming-out of the recession. Most influential American economists were once again split into two parties on value, theory and politics: those who supported state intervention and restoring weakened financial and real sector (especially automotive industry and construction) and those who were against.

Conditionally speaking, professionals were split into followers of economic philosophy of 'visible hand' of Keynes or 'invisible hand' of Adam Smith and followers of 'supply economy' of the grand guru Milton Friedman. The second largest recession revived not only the theory of Keynes but in many parts of the world, especially in South-America admirers and followers of inheritance of Karl Marx were revived as well.

After President Obama stated on 9th January 2009 that 'there is no misunderstanding around the fact that state intervention is needed in the form of a plan supporting economic recovery', 200 economists were convoked by the quite influential Cato Institute supporting principles of free venture and free market operation with minimal state intervention, who questioned in public the accordance stated by the president concerning economic life of the country. They confirmed the following statement by their signature published in a complete-page article of New York Times:

'With all our respect, Mr President, the truth is not that we agree. Although it is said that each economist is Keynesian and that all of us agree with increasing state influence, we do not believe that the right way to a rise in economic results would be more massive state spending. Higher state consumption did not bring out either President Hoover or Roosevelt from the Great Crisis of the 30s and it did not save the 'lost decade' of Japan in the 90s. Belief in higher state spending getting out America from trouble today is only victory of hope over experiences. Politicians are only able to help economy by averting obstacles ahead of work, saving, investment and production. Tax and state charges decrease is the best way to let means of fiscal policy to support growth".[5]

It is worthwhile to mention that Croatian professor dr. Pavel Šavor from Pennsylvania University acted as anti-Keynesian.

Although followers of state intervention did not create a formal group, by singing open letters and appeals their names are known for the public and their theoretical standpoint is influential in today's America. Best-known actors among so-called new-Keynesians are George Akerlof, Ben Bernanke, Olivier Blanchard, Alan Blinder, Stanley Fischer, Jordi Galí, Mark Gertler, Robert J. Gordon, Nobuhiro Kiyotaki, Paul Krugman, N. Gregory Mankiw, Maurice Obstfeld, Edmund Phelps, Kenneth Rogoff, David Romer, Julio Rotemberg, Nouriel Roubini, Andrei Shleifer, Lawrence Summers, Robert Shiller, Joseph Stiglitz, John B. Taylor and Michael Woodford.

End of 2008 and beginning of 2009 was characterised by not only theoretical and political disputes of economists on possible strategies to boost economy but also rivalry of pessimistic prognostications of new-Keynesians.

At the very beginning of 2009, on 9th January Nobel Prize winner Paul Krugman described as follows the situation of American and global economy in New York Times, the most influential newspaper in the world:

'It is reality that economic indicators are terrific not only in the US but all over the world. Industrial production is shrinking everywhere. Banks are not giving loans, business and citizens are not spending. Do

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attempts of which the most important is IDEAS. Based on this ranking the 10 most celebrated economists in 2010 are: 1. Joseph E. Stiglitz, 2. Andrei Shleifer, 3. Robert J. Barro, 4. James J. Heckman, 5. Robert E. Lucas Jr., 6. Martin S. Feldstein, 7. Peter C. B. Phillips, 8. Daron Acemoglu, 9. Jean Tirole i 10. Edward C. Prescott. (http://ideas.repec.org/top/top.person.all.html)

[4] Package of measures of Obama-administration to boost economy was passed by the Congress in February 2009. Nominal value of it was 787 billion dollars and was included in the law ARRA, *American Recovery and Reinvestment Act of 2009* (Pub.L. 111-5). Economic program of the new administration is logical continuance of the two acts passed in 2008 in the last year of the Bush administration in order to get over the recession: *Economic Stimulus Act of 2008* and *Emergency Economic Stabilization Act of 2008* supporting TARP, *Troubled Assets Relief Program*.

[5] The report is approachable: www.cato.org/special/stimulus09/alternate_version.html

not abuse ourselves: this (economic setback) indeed seems to be the beginning of a second great global economic crisis.' (Krugman, 2009a)

He continued his catastrophic predictions in his blog, in many of his articles and in the occasion of his public coming outs. He regularly used expressions from epistemology and group philosophy like economic catastrophe, edge or submergence, inferno and swirl.

In his article titled *On The Edge* published on 6th February 2009 in New York Times, Krugman explained two radical theory of the future of the American economy strongly related to each other . First was: 'the American economy is at the edge of an economic catastrophe', second was: 'Washington lost its sense of reality. Here all it is about is that we can easily get in an economic swirl of which it will be difficult to get out once we have already fallen in.'

His suspicion of the New or Second Great Global Economic Crisis was the reason why Krugman was intractably insisted on his standpoint: fiscal policy of the US in 2009 and 2010 needs to be based on stimulating financial and economic activity, reducing unemployment and producing economic growth instead of deficit.

'It is politically fashionable to criticize state spending and demanding fiscal discipline. At this point of time rise in state spending is what an excellent doctor would order. Fear of state deficit must be set apart now.' (Krugman, 2008b)

Justin Linn, leading economist of World Bank is situated very close to pessimism of Krugman who characterized prospects of global economy at the beginning of 2009 as follows:

'At this moment it seems that the consequence of this trouble will be the greatest financial crisis ever seen since 1930.'[6]

Another Nobel Prize winner, Joseph Stiglitz is also approaching to this view who said in his presentation the following for Serbian businessmen, experts and politicians in Belgrade at Hyatt Regency Hotel in December 2008:

'Due to negative factors of globalization the crisis spread over other parts of the world from the US. Therefore it is possible that Europe needs to face with even greater economic chaos than it was seen in the US that would hit Central and Eastern European countries more as they are strongly dependent on their more developed neighbours.'[7]

He took the opportunity and spoke about the situation of Serbia as being 'less integrated country' and he said the followings:

'Serbia has the chance to avoid this crisis affecting the whole world but it is true in general that only a few countries will not be damaged. It is possible that less integrated countries will be less damaged than others who are more dependent on foreign investors due to their developed status.'[8]

Contrary to Krugman, Stiglitz, Justin Lin and red economists, professors of economic history thought that first financial crisis of 21st century is not a possible second world crisis but recurrence of history. In this regard, the best writing of those published in this issue[9] proved to be '*This Time is Different: Eight Century of Financial Folly* written by Carmen M. Reinhart[10] and Kenneth S. Rogoff[11]. This writing is thematically similar to the famous monograph of Charles Kindleberger from 1989 titled *Manias, panics and crashes: A history of financial crisis,* however it is significantly different regarding its methodology. While Kindleberger used narrative and descriptive method to analyse history of financial crisis, the other two authors applied statistical viewpoints and supported the results of their analysis by numerous diagrams and graphs.

By applying methodology of international historic analysis, examining relation of financial and real sector between 1900 and 2008 (examination period between 1800 and 2008 was also used sometimes) authors

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[6] *Global Economic Prospects: Commodities at the Crossroads 2009*, http://siteresources.worldbank.org/INTGEP2009/Resources/10363_WebPDF-w47.pdf.

[7] Radio B-92, 21th January 2009, http://www.b92.net/eng/insight/interviews.php.

[8] Uo.

[9] Literature on economic crisis is written not only by scientists but also by financial advisors, financiers, journalists and others.

[10] Carmen M. Reinhart is professor of economics in Maryland University and frequent lecturer at academic forums of MMF and World Bank

[11] Kenneth S. Rogoff is professor of economics and politics at Harward, earlier leading economist of MMF and regular expert of Financial Times and Wall Street Journal. He strongly supported interventionism of America and other states. He stated at the World Economic Forum in 2009 that being worried about inflation nowadays is something like being worried about pox when there is danger of black death. (http://csrinternational.blogspot.com/2009/02/davos-2009-quotable-quotes.html)

managed to prove that latest financial crisis is not an exception but normal example of cyclic crisis through history.

They also demonstrated that not only national and global crisis but their social and economic consequences show historic regularity as well.

Reinhart wrote the followings about this issue:

'Sharp *economic downturns* follow banking crises; with *government revenues* dragged down, *fiscal deficits* worsen; deficits lead to *debt*; as debt piles up *rating downgrades* follow. For the most fortunate countries, the crisis does not lead to the deadliest D: default, but for many it has.'[12]

Reinhart should have added two more factors to the above mentioned ones: fall of real estate prices and increase of unemployment. A study analysing banking crisis of developed countries after the Second World War comparing eighteen thousand cases (highlighting five cases: Spain in 1977, Norway in 1987, Finland and Sweden in 1991 and Japan in 1992) showed that these crisis have measureable effects on real economy and market relations. The study was carried out based on the following aspects: (a) fall of real estate prices, (b) fall of share prices, (c) rising unemployment, (d) decreasing GDP and (e) increasing state debt.

Table 1.1. Average consequences of 18 banking crisis of developed countries between 1945 and 2008

Consequence	*Percentage*	*Term* (*in years*)
Average decrease of real estate prices	35.5	6.0
Average shrinkage of share prices	55.9	3.4
Average raise of unemployment	7.0	4.8
Average fall of GDP	93.0	1.9
Cumulative growth of state debt	86.0	

Reinhart and Rogoff point out excessive aggregation of debt as common denominator of financial crisis and the phenomena following them.

'If common substance exists in case of the different crisis we examine in this book then it must be excessive accumulation of debt. No matter if state, banks, companies or consumers raise debt, it means much higher risk on a systemic level that first it seems to be. By capital injection state suggests higher economic growth than it is in reality. Indebtedness of private sector can spectacularly increase prices of real estates and shares above certain level sustainable in the long run creating illusion of stability of banks and profitability, but it is only a bubble. Such a high increase of debts also pushes economy into crisis of trust especially in case of short-term debts requiring continuous refinancing. Boom which is based on debt assures untrue affirmation for politics, possibility of great profits for financial institutions while it guarantees short-term increase of standard of living for citizens of the country. These kinds of booms usually end by failure. (Reinhart, Rogoff, 2009b: xxv)

I think the above thoughts are instructive and warning for many highly indebted enterprises and states thus for Croatia as well. Between 1995 and 2008 Croatia built great part of its economic growth upon uncontrolled internal and external indebtedness[13] due to availability of 'cheap funds'. In the forthcoming years it will be a serious problem that these funds, both credits and foreign direct investments will become available with difficulties and 'expensive'.

It is however difficult to judge today how the first financial crisis of the 21st century, that does not even have generally accepted name, will look like in a historical view. Generally speaking this crisis caused a conceptual and discursive shock because of usage of expressions that are not yet clear in their meaning and contents.

Economic experts apply diverse terms for describing economic problems: *retardation, stagnation, stagflation* (stagnation of economic growth with appearance of inflation), *recession* and *depression*.

In especially difficult situations expressions of *chaos* and *crash* are used as well.

Discursive difficulties of these expressions are illustrated very well by their incidence on the internet. On 10th January 2010, by using Google search, order of occurrence of expressions in Croatian and English documents was the following:

Table 1.2. Number of Google documents containing searched expressions (on 21th January 2010)

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[12] Reinhart, 2009c

[13] Reinhart and Rogoff paid particular attention to hide internal indebtedness among statistical for many states, especially in case of short-term debts that can easily create panic.

Rank	*Expression*	*Number of occurrence*
1.	Crisis	152,000,000
2.	Depression	71,200,000
3.	Recession	35,300,000
4.	Financial crisis	16,600,000
5.	Economic crisis	9,900,000
6.	Great depression	6,580,000
7.	Economic recession	1,590,000
8.	Economic depression	540,000
9.	Great contraction	245,000

These expressions with identical or similar meaning have too many normative and grammatical definitions hence they cannot always be applied so accurately to avoid any semantic, theoretical or political misunderstanding.

For example most of the experts agree that we call every case *recession* when GDP is shrinking throughout two quarters at least. However, because of plurality of circumstances and consequences we need to consider other measures of recession like fall of industrial production, raise of unemployment, shrinking investments, decreasing real estate transactions, fall of consumption, etc.

Depression is not grammatical privilege of economics either as it is originally a psychological and psychiatric term.

Grammatical problems are probably caused because expression of *crisis* itself has numerous nuances of meaning.

The following phrase is an excellent example for grammatical inventiveness: recession is when our neighbour lost his job; depression is when I lose my job; economic crisis is when both of us lost it.

Expression of *great contraction*[14] was first used by Milton Friedman for crisis of '30s.[15]

Theory of boom related to excessive indebtedness and financial sector with fierce innovation[16] was mostly supported by three economists who were condemned by other professionals to be followers of economic apocalypse and excessive pessimism that time when the dominant direction was economic optimism.

One of them was *Robert James Shiller*, professor of economic behaviourism (more precisely of financial behaviourism) at Yale University. He was the only economist in the world who forecasted both of the two financial crisis of the 21st century based on a simple historical-statistical analysis; stock exchange crisis of 2000 and economic crisis of 2007. In the middle of '80s with his colleague John Campbell, Shiller developed a system for measuring real value of stocks. Price-earning ratio served as starting point at corporate and other shares. This ratio is standard measure of share value and thus it regularly appears on stock exchange. The difference was that stock exchange creates this measure based on a previous period (usually using previous year) while measure of Shiller used a period of ten years. In order to prove that variation of the measure they constructed may correlate with rate of recession, they prepared statistical analysis for period between 1980 and 2000 (when Shiller announced the fact of recession and collapse of internet superpowers) and later for a period until 2005 using calculations of another measure. Based on the *Case-Shiller index* which has used ratio of real estate prices and household revenues, Shiller announced arrival of the current great global crisis and the fact of recession following it.

Underrated for years and becoming jest among professionals (especially among followers of service economy and general market deregulation), Shiller today is called *The Bubble*[17] which is not at all a cognomen, it is rather symbol of acknowledgement and respect.

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[14] Other synonyms applicable are contraction and restraint.

[15] The expression first appeared as a chapter title in 'A monetary History of the United States, 1867-1960' written by Milton Friedman and Anne Jacobson Sshwartz in 1963. After primary statement of the authors the Great World Crisis was indeed a great contraction that lasted for a long time due to the failure of monetary policy of the American Central Bank. New edition of the tome was published in 2008 by Princeton University Press with introduction written by A. J. Schwartz.

[16] Innovative financial sector especially shadow banking system are such huge systems and development of their financial instruments are so rapid and frequent that stock exchange agents are not able to follow them so easily as researchers are at universities engaged in banking, insurance and finance.

[17] Meaning of the expression 'bubble' in this context is untrue venture, loss of value, cheating and ramp.

Shiller's book *'Irrational Exuberance'* first published in 2000 announcing market collapse of internet economy and stock exchange crisis following it was published second time in 2005. The new edition also includes graphs of calculations based on the index he developed with Karl Case. The new indicator was created based on the persuasion that real estate prices must follow basic economic logic in the long run (except special geographical sites where there is no possibility for further construction at all) that means they need to vary based on principle of 'construction cost plus normal return'. Easily accessible 'cheap' credits, shadow banking system and stock exchange speculations artificially generate greater demand on real estate market creating economic bubbles that necessarily need to collapse. Using expressions of Marx: artificial boom is followed by hyper-production crisis, fall of real estate prices and expensiveness of money (because of insolvency caused by raise of interest rates) and finally all of it drives to latent crisis of financial sector.

By successful prognosis of the two crisis Robert Shiller managed to book not only personal compensation and media success but he could also highlight dominancy of mathematic calculations in the area of stock exchanges. This dominancy was born in 1952 at Chicago University when a student, Harry Markowitz made stock exchange risk equal to certain mathematic variant. Justin Fox explains in his book *'The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street'* appreciated by Paul Krugman in New York Times[18] that a new financial doctrine had been developed that did not examine behaviour of investors any more but it rather required its investors to learn how to behave after CAPM *(Capital Asset Pricing Model)*. For his academic finding *Harry Markowitz* received Nobel Prize in 1990 together with *William Sharpe* and *Merton Miller*[19]. Since behaviourist economics is currently being celebrated we may assume that next Nobel Prize will also be taken by a behaviourist economist; currently Shiller seems to be the most probable winner.

In 2009 Shiller was awarded the Deutsch Bank Prize in Financial Economics and his new bestseller *'Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism'* (2009) written together with Nobel Prize Winner George A. Akerlof[20] is currently considered as required reading in America of which we can learn everything about nature of economic crisis and economic behaviour of people, enterprises and states.

The title of the book is citing John Maynard Keynes who considered animal spirits as one of the most important factor of economic life and behaviour. In addition, the authors say that in our current world with developed communication networks feelings play dominant role in economy, market behaviour, job taking and consumer behaviour contrary to Adam Smith and his circle's natural science view.

Shiller and Akerlof are entitled to say what is already well-known among marketing experts: feelings of security-uncertainty, trust-mistrust, justice and honesty as well as desire for enrichment for any price even through fraud all affect economic behaviour of individuals, institutions and states.

Another economist who attained American and worldwide success by predicting the crisis was *Nouriel Roubini*[21], professor of University of New York who, after his pessimistic forecasts was simply called *Dr. Doom*[22] by his colleagues. He got his nickname from a colleague at University of Georgia Stephen Mihm who published a broad article on 15th August 2006 in New York Times about how Roubini came out as an economic prophet.

'On Sept. 7, 2006, Nouriel Roubini, an economics professor at New York University, stood before an audience of economists at the International Monetary Fund and announced that a crisis was brewing. In the coming months and years, he warned, the United States was likely to face a once-in-a-lifetime housing bust, an oil shock, sharply declining consumer confidence and, ultimately, a deep recession. He laid out a bleak sequence of events: homeowners defaulting on mortgages, trillions of dollars of mortgage-backed securities unraveling worldwide and the global financial system shuddering to a halt. These developments, he went on, could cripple or destroy hedge funds, investment banks and other major financial institutions like Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation).' (Mihm, 2008)

Although Anirvan Banerji, executive of Economic Research Institute of New York was trying to moderate the audience by explaining that previous statements were not founded on statistical data and mathematic calculations so they were rather examples of economic pessimism, the created affect was

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[18] Paul Krugman, '*School for Scoundrels*', *New York Times*, 6th August 2009, http://www.nytimes.com/2009/08/09/books/review/Krugman-t.html.

[19] http://nobelprize.org/nobel_prizes/economics/laureates/1990/.

[20] Akerlof shared Nobel Prize with Michael Spence and Joseph E. Stiglitz in 2009.

[21] Biography of Roubini: http://en.wikipedia.org/wiki/Nouriel_Roubini

[22] Dr Doom, brilliant inventor, warlock and prophet was character in comics *Fantastic Four* written by Stan Lee and Jack Kirby.

sufficiently drastic. Prakash Loungani, economist of MMF inviting Roubini two times to be lecturer said to Mihm: 'In 2006 we thought he was a fool. In 2007 he returned as a prophet.' (Mihm, 2008)

Today Roubini is already the most influential economist both politically and publicly and he is also a real media star: He attained the 81st place among 'The 100 most influential people of the World' in 2009 published in *Times* magazine (retrospect by Paul Krugman[23]). In English magazine *Prospect* he took the second place on the list of Britain's top 100 public intellectuals in January 2009 (the list was created by readers' voting). *Foreign Policy*[24] considered him as well being 4th among the top 100 global thinkers.

Today when academic and political influence highly depends on public reputation, the fact that Roubini was prophet of crisis brought greater interest that the method itself helping him to forecast it.

At the end of 2009 he launched his own homepage continuously following and commenting economic events of the world.[25]

It is important to know about him that contrary to Shiller he does not apply mathematic models, statistical data and constant indexes in the course of his consultancy to banks, enterprises and states. His statements are evidence of an exceptionally rich, colourful and global professional experience, careful monitoring of economic processes and something that may be called as *economic imagination*.

His official biography[26] proves that we really can speak about a 'global nomad' how he calls himself: he was born in Istanbul as child of an orthodox Iranian Israelite, he spent his childhood in Teheran, he was student at Jewish University of Jerusalem, he graduated as an economist in Italy in 1982, after that he obtained doctorate at Harvard University (where his mentor was *Jeffrey Sachs*). He educated at Yale (where he worked together with Shiller to whom, as he said, his ability of economic forecasting is attributable), he was associate at IMF and American Central Bank, he was economic advisor of president Clinton and as a participant he studied crisis of the 90s (Mexican in 1994, Asian in 1997-98, Brazilian and Russian in 1998, Argentinian in 2000).

According to Roubini the reason why contemporary modelling economists cannot predict crisis in advance is their deficiency that they do not take into consideration factors of human behaviour, which rises from their engineering empiricism. His favourite author the post-keynesian financial analyst *Hyman Minsky*[27] was engaged in this topic in the course of his works in detail and with pleasure.

Due to his great public (and not so much professional) success Roubini has an impact that makes his articles be considered as particularly academic or intuitive-epistemologic prognostications. His article *The Decline of the American Empire* published in 2008 (in which he considered financial crisis as last symptom of decline of military, political and economic dominance of United States) was also interpreted similarly by American politicians.

It is certified by his article *Warning: More Doom Ahead!* published in 2009 in *Foreign Policy* that there might be some truth in critics concerning his perpetual pessimism. We can read the following prognosis for year 2010 in the magazine:

'Last year's worst-case scenarios came true. The global financial pandemic that I and others had warned about is now upon us. But we are still only in the early stages of this crisis. My predictions for the coming year, unfortunately, are even more dire: the bubbles, and there were many, have only begun to burst.' (Roubini, 2009)

Hyman Philip Minsky (1919-1996) is the third economist who was made famous by the crisis, however only after his death. It mainly could happen due to his respecters, particularly to Nouriel Roubini and Paul Krugman.[28] After the years spent at Brown (1949-1958) and Berkeley (1957-1965) he finished his career as professor of Washington University of St. Louis.

Being follower of John M. Keynes and adversary of Chicago School, market fundamentalism and reaganomics, he developed his theory already in 1992 on inherent uncertainty of contemporary financial systems and cyclical characteristic of our willingness for crisis.

[23] Paul Krugman, "Nouriel Roubini", *Time*, 30th April 2009.
http://www.time.com/time/specials/packages/article/0,28804,1894410_1893209,00.html.

[24] "The FP Top 100 Global Thinkers", *Foreign Policy*,
http://www.foreignpolicy.com/articles/2009/11/30/the_fp_top_100_global_thinkers?page=0,3.

[25] http://www.roubini.com/analysis/88644.php

[26] http://pages.stern.nyu.edu/~nroubini/referen.htm

[27] http://en.wikipedia.org/wiki/Hyman_Minsky

[28] Krugman dedicated several retrospects to Minsky in New York Times, in his own blog and in his discourse *The night they reread Minsky*; http://www.princeton.edu/~pkrugman/Lecture%203.pdf

Right after his death, CEO of PIMCO Paul *McCulley*[29], called his hypothesis 'The Minsky-moment' after the statutory process in which uncontrolled financial expansion drives to crash. Later the above expression played crucial role in the discussions on economic crisis of 2008 to 2010.

He published his theory on inherent uncertainty of contemporary markets in 1992 with title '*Financial uncertainty'*, in the period when reaganomics had its golden age and America as a whole was in a fever of economic, political and military victories. His above mentioned work was followed by furthers after the Asian crisis of the '90s. In the focus of all his works is his statement saying that during growth of market and stock exchange – in bull markets – economy is pushed towards recession and crisis by uncontrolled accumulation of debt.

He named three groups of actors of stock exchange who drive economy intentionally first towards financial crisis then to general crisis: hedge borrowers, speculative borrowers and Ponzi borrowers.

He described the following phases of financial cycle: 1. Displacement, 2. Boom, 3. Euphoria, 4. Profit taking, 5. Panic. The Minsky-moment is the moment in business and financial cycles when investors face lack of cash flow or the phenomenon that they cannot pay back their current instalments because they got into a debt-spiral in order to cover their previous debts. By this moment they start to panic and they are pushed to get rid of their fortune naturally inducing fall of prices. The Minsky-moment reached some, seemingly successful Croatian enterprises: Glumina Banka, SMS, Peveca and others. Consequently, by this moment a wider financial and economic crisis starts (and probably has just started).

Despite the infrequent 'prophets' we previously mentioned economic experts have not yet managed to develop any method by collecting samples to forecast and define economic downturns. They mostly agree on the reasons and the definition of their circumstances however opinions are very different regarding the ways to handle them and the possible strategies against downturns[30].

First of all, experts agree that starting point and metaphoric epicentre of the financial crisis is most probably situated in the American economic sector, primarily in real estate market and construction. More accurately, we may search for the reasons of the crisis in the build-up of loans for buying apartment. During the quest for causes and starting points, subprime mortgage, a special American mortgage proved to be the final agreed denominator for the experts. As Paul Krugman said it is a mortgage available even for those who are not solvent (Krugman, 2008a xiii).

One of the ample explanations makes the above statement more clear:

This mortgage is the kind of mortgage that is used mostly by requestors with low solvency. Users of subprime loans usually do not comply with conditions for credits with lower interest rates, either as they have never been claimants or because they possess a bad 'credit past', consequently they are considered to be risk factors by reviewers. Due to the danger of indebtedness arising from non-payment of instalments the annual percentage rate can also be higher in these cases.[31]

Blooming of subprime loans[32] can easily be explained by considerable change in built-up of loans for buying apartment. Classic bank administration that has based its loan policy before on accurate evaluation of financial standing and knowledge of real market value of real estate faced an unknown situation in the last decade. Interest rate-project of Economic and Integration Bank of Central-America, accomplishing a 1% rate from 11th September 2000 till 2004 granted abundance of 'cheap money' for all banks. The other factor that might be even more important was the raise of real estate prices, especially in case of apartments and houses. This raise emancipated banks out of risk of insolvency as in latter case, being new owner of the real estate they could sell them on a much higher price than the amount of the loan. The third and most important factor was that subprime mortgage as a product was easily marketable in the so called shadow banking system, namely on secondary financial markets and on stock exchanges. Stock exchange of mortgages gained new dimensions in the past decade because China, the oil states, more European states and financial institutions (mostly open and closed investment funds) invested much more in American real estate expecting higher benefits due to new conditions.

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[29] More about his biography: http://en.wikipedia.org/wiki/Paul_McCulley

[30] Financial entrepreneurs proved to be much better diagnosticians. One of the most rich persons of the world Warren Buffett for example, in his letter addressed to the shareholders of Berkshire corporation, called innovative financial instruments as timed bombs appropriate for mass destruction that may cause unforeseeable damages in world economic system.

[31] InvestorWords.com, http://www.investorwords.com/6688/subprime_mortgage.html

[32] In America cultural motivation is much more important than economic reasons as possessing a real estate means the American dream coming true.

In his bestseller *Financial Shock,* Mark Zandi pointed on the fact that annual average yield on apartment market was 12% in 2000 while in case of office buildings it was 8.5%, for purchase of bonds of ministry of finance it was 6% and for stocks of Standard & Poor's it was 3%. (Zandi, 2009:62)

Enormous yields of owners and managers of banks, stock exchanges and investment funds attracted new speculators called *flippers* to the real estate markets consequently this market was no more a place where average citizen could realize the great American dream but primarily it was a place for financial engineering and innovations for new financial development and products. The most developing products were mortgage-backed securities (MBSs), collateralized debt obligations (CDOs) and the credit default swaps (CDSs).

According to posterior estimations (based on data of Encyclopedia Britannica) liabilities of users of subprime loans came out at $450 milliards in 2005. The above mentioned loans usually worked on a fix interest rate in the first two years.[33] When Central-American Bank suddenly raised the previously 1% rate to 5.25%, a huge chaos came, first on real estate markets later both on American and on global financial markets.

In the first half of 2007 due to the new conditions 6 million clients became insolvent resulting in a 21% drop of real estate sales in August. After that, financial crisis and recession necessarily extended based on the butterfly-effect.

Serious price variation of real estate is not necessarily an American phenomenon: between 1997 and 2007 average prices raised by 253% in Ireland, 194% in Great-Britain, 173% in Spain, 137% in France, 135% in Austria and 124% in Sweden.[34]

It highly contributed to the quick spread of the crisis that the greatest European, Asian, Near-East and Austral financial institutions were all present through huge deposits on the American financial and real estate market.

Differences of studies on reasons of the crisis may not be visible on the surface however they are very different considering political and economic aspects. More international experts see roots of the crisis in the Breton Woods system in which the gold-secured American dollar served as a financial gauge and backup for other currencies. Latest financial, economic, political and demographic reality shows that it is necessary to notice the logical system *Nouriel Roubini* already mentioned in his essay *The Decline of the American Empire*.

However, the most considerable experts and intellectuals are thinking about something else. The theory of sustainable development requires humans to break with the dogma of constant and fast growth; it calls on taking responsibility affecting individuals, economic creatures as well as countries and international organizations. We need to take this responsibility for the nature, our brethren, the poor, humanity and the future of the World.

Besides systematic reasons of the crisis impregnated in radical economic liberalism and market fundamentalism and easily managed to be found by historic research, the reasons created in the course of macroeconomic decisions should not be underrated either.

That is why the article '*Capitalist Fools'* written by Joseph Stiglitz, published in January 2009 in *Vanity Fair* is very important. The article is exceptional mostly because it comes from a Nobel Prize winner and as it was published in a journal presenting the life of the American upper middle class, the rich and the famous. The article and its author are part of a new professional and cultural trend in which leading contemporary scientists are reforming their methods of communication, using for example magazines, blogs and community portals such as Twitter and Facebook instead of classic media and the already used formulas of public appearance. The article which is not so long and reader-friendly is listing five key factors (decisions and processes) that, after the author's opinion, led to the evolution of the present economic situation. These factors appeared during the period from the 30s until nowadays while there were three republican presidents in White House: *Ronald Wilson Reagan* (1981-1989), *George Herbert Walker Bush* (1989-1993), *George Walker Bush* (2001-2009) and one democrat, *William Jefferson Clinton* (1993-2001) who by the way employed Stiglitz as his councilor.

The first reason was the decision of Reagan in 1987 when he named Alan Greenspan as head of the American Central Bank instead of Paul Volcker who held the position before. Stiglitz thought that Volcker did what he had to do in his position: decreasing the inflation from 11% to 4% and following a monetary policy which insures economic growth (while controlling other banks). He said Greenspan was initiator of the crisis, being oppositional to all forms of economic control.

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[33] *Encyclopædia Britannica*, www.britannica.com/EBchecked/topic/1517396/Subprime-Mortgages-A-Catalyst-for-Gl

[34] Uo.

The second reason was the decree drawn by Senator *Phil Gramm* in 1999 that abolishes difference between commercial and investment banks, after the financial institutions already spent 300 million dollars on lobby in the Congress. After this decision all banks in America became investment banks and traditional banks were forced to play hazard. After that the financial innovations became timed bombs and “weapons of mass destruction” (after *Warren Buffett*).

The third reason was the new economic and military policy of George W. Bush in 2001 that, Stiglitz thinks, was the main reason of the crisis. Its key elements are: (a) tax decreases, (b) decrease of the interest rates of the American Central Bank, (c) tax relief extended to all investments, also to investments in real estate,[35] (d) war with Iraq that led to the rise of the oil prices and the radical increase of the American budget deficit. Redundancy of money and unregulated environment led to secondary loans and appearance of ‘economic bubbles’ in the real estate market.

The fourth reason was the cascading of the classic budget and auditory system in the middle of 2002. Optional shares made managers of financial institutions overrule totals of invoices as their income was dependent on accountant statements. Stiglitz also found the financing of credit rating agencies as a reason for the crisis because the agencies are sustained by those who are rated. Innovative financial solutions made it possible to fake value and both inland and foreign investors could be stiffed who in fact did not have a clue on the object of their investments.

The fifth reason was that, according to Stiglitz, the source document proposed as a relief package on 3rd August 2003 by minister of finance *Henry Paulson* contained only three pages. Based on the document Paulson claimed 700 million dollars that he could use at his discretion without any control or legal monitoring. This was action of exceptional arrogance and led to production of ‘cash for trash’ by the previous government. Stiglitz considered this document as a good example of ignorance, irresponsibility and shallowness that was typical in handling finance by the Bush administration, taking international markets into huge crisis during these years.

Above posterior (and quite late) slam of the 30-year financial policy of the White House foreshadows the professional sense of guilt obsessing Stiglitz, since these years he often sat in the committee and took decisions with Greenspan or the minister of finance *Robert Rubin.* He stated that he had already recognized the danger being on the lark with his colleagues however they could not do anything since the two central institutions, the American Central Bank and the Securities and Exchange Commission committed themselves contra action.

The example of opposition between Stiglitz as a politician and as a scientist shows the phenomenon how difficult it is to adopt an economic theory in political and business routine. The phenomenon is not unique – being employee of the World Bank the author could notice it in case of scientists who were frequenters as advisors at the organization.

I attended lectures of the following experts in spring 2008: Nobel Prize winner *Douglass North*, researchers of increase and development *Fani Rodrik* and *Daron Acemoglu* and *Francis Fukuyama*[36] who was dealing with systems of international relations. Subject of the lectures and talks was the state government and possible decisions on increase and development.[37] Although approaching the topics from a different point of view they were decidedly in accordance in one statement: during the crisis, development theory of Schumpeter is probably the most traceable standard for all financial organizations (from international companies to national economies). The model which is well known after its key notion “creative destruction” was published by the Austrian scientist in his writing *Capitalism, socialism and democracy*[38] founded on the philosophy of Mihail Alexandrovich Bakunjin, Friedrich Nietzsche and Werner Sombart.

The substance of the model is comparison of corporate systems and capitalism to evolutional systems that can grow, develop or die. It is necessary to create internal creative destruction patterned according to natural selection in order to prevent overgrowth leading to crush. The destruction thus means an institutional and technical progress that insures giving up old and unnecessary while creating new and better.

It seems to me that the theory of generative destruction can easily be adopted in other segments of economic sciences. Besides classic paradigms of economic liberalism and interventionism, a third system of approach appeared and stands out more and more, initiating probably a golden middle way. I would call this trend *societal-side economics* and I believe in its reason for existence.

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[35] Consequently all loans related to investment in real estate went hand in hand with tax relief.

[36] Fukuyama’s triumphal theory *The End of History* that he published after final victory of capitalism over communism, considering current problems seems to be hilarious.

[37] *Governance, Growth, and Development Decision-making*, World Bank, 2008

[38] Title of latest American edition is: *Can capitalism survive*?

Results of research named in this article and other researches disputing interdisciplinarity of social responsibility are oriented towards one question: shall we suppose a third way besides doctrines of demand side economics and supply side economics? These researches gain their real meanings through the work of followers of free market and in activity of the 'world association' acting in the domain of sustainable development, environmental and social-political sensibility.

However, the present situation in the world and professional dialogue around it make us think about how we can create and sustain a global, ecologically and socially responsible economic system in the future.

From Croatian original translated by Erzsébet Katalin Nyeste

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Thank you for your kind collaboration. *Editor-in-Chief*