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## **ECONOMIC CRISIS: CHALLENGE FOR ECONOMIC THEORY AND POLICY**

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### **Abstract**

Crises are truly social phenomenon and that is why they have strategic importance and require increased state regulation. The global economic crisis of 2008 has rapidly mastered the world and significantly affected national economies. The aim is to show that economic crisis has always represented a great challenge for economic theory and policy, and that the theoreticians and practitioners demonstrated the need to create a new model of economic growth and change the dominant theoretical paradigm. There are many findings but the most important ones are as follows: The recent crisis has shown how unregulated market can lead capitalism to its disaster. Neoliberal doctrine had a strong negative impact on policy which helped spread of the crisis. It was a sign that it is necessary to create a new theoretical and macroeconomic paradigm and a new model of economic growth that would be the answer to the recent economic crisis because it has shown that the neoliberal mode of economic policy has been wrong and ineffective in terms of the global economic crisis. In process of continuous global changes, it is necessary to build a stable society, which is going to be humane and socially balanced.

**Keywords:** Economic Crisis, Economic Theory, Economic Policy, Macroeconomic Paradigm, Model of Economic Growth

**JEL Classifications:** E12, E13, E32

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### **1. Introduction**

Economic crisis in economic sciences is a period of significant negative economic development of a country. It can cover one or more economies, one economic branch all over the world, or whole world economy. According to Keynes (1964), crisis presents process of capital depreciation. When a specific form of capitalism enters its crisis phase, this eventually gives rise either to a new form of capitalism or to a transition beyond capitalism (Kotz, 2009). Economic crisis has always presented a great challenge for economic theory and policy. Regardless of

continuous researching of crisis causes and consequences from the perspective of economic theory and policy, crisis has been and will remain a society phenomenon. Problem of economic crisis has its multidisciplinary character because of the fact that it does not only have economic implications but also political and social ones. Capitalism has been going through the crisis frequently but it is interesting that it has survived all of them. We can say that gentle variants of crisis in capitalism are like cold, which means that they are periodic disorders followed by recovery. Current world economic crisis and its consequences in economy and economic policy of some national countries has produced disbelief and fear. It presents the greatest challenge of mankind in the beginning of twenty-first century. According to Obstfeld and Rogoff (2009), it was not just about excessive liquidity on to the US market, but excessive liquidity has been characterized by most countries. Economic crisis made in USA has spread all over the world and it got a name: First global financial crisis of the 21st century (Felton and Reinhart, 2008). All economies, regardless of the development level, tried to reduce consequences of the crisis applying appropriate measures of monetary and fiscal policy. In period of crisis, a space for economic actions in market economy is much higher than in normal circumstances. Modern economic theory and analyses of economic development has discarded neoliberal dogma that market is basic factor of macroeconomic relations in reproduction.

Stiglitz (2006) pointed to the most profound consequences of neoliberal ideology in modern capitalism: deepening of social polarization between states, but also of the citizens themselves, endangering the balance of the eco-system and the creation of the instability of the international financial system. Stiglitz (2010a) emphasizes that few years ago, during Asian crisis, there was a discussion about some serious reforms of global financial system trying to avoid possible economic crisis in the future. Economic policy on global level is faced with many challenges. It must be at the same time proactive and reactive and that produce some more negative consequences which affect process of implementation of appropriate economic policy. The general aim of the research is to confirm that economic crisis was always a major challenge for the economic theory and policy, and that the crisis of 2008 pointed out to the theoreticians and practitioners that they need to create a new model of economic growth and to change dominant theoretical paradigm. After introduction part, this paper would present theoretical bases and hypotheses, research methodology, research findings and conclusion remarks.

## 2. Theoretical Bases and Hypotheses

Business cycles after expansion become recognizable by phase of worsening which is called crisis. It can be defined as unplanned and undesired process which can threaten or completely disable development possibilities of economy. Economic crisis in economic sciences is a period of significant negative economic development of a country. In addition to this definition, economic crisis also means existence of negative trends of main macroeconomic indicators (employment rate, prices, GDP growth rate, export, capital flows, etc.). Table 1 presents some trends of global economic indicators such as GDP growth rate, growth of world trade and CPI. Table 1 includes developing and developed countries. We can see, after looking at Table 1, that crisis means interruption or slowdown of normal trend of economic growth and development with strong and negative reflections on major variables.

**Table 1. Global economic indicators**

|   | Year |      |       |      |
|---|------|------|-------|------|
|   | 2007 | 2008 | 2009  | 2010 |
| Real growth of BDP-a, (%)                 |      |      |       |      |
| - World (total)                           | 5.2  | 3.0  | -1.1  | 3.1  |
| - European Union                          | 3.1  | 1.0  | -4.2  | 0.5  |
| - USA                                     | 2.1  | 0.4  | -2.7  | 1.5  |
| - Developing countries                    | 8.3  | 6.0  | 1.7   | 5.1  |
| Growth of world trade                     | 7.3  | 3.0  | -11.9 | 2.5  |
| CPI-consumer price index (annual changes) |      |      |       |      |
| - Developed economies                     | 2.2  | 3.4  | 0.1   | 1.1  |
| - Developing economies                    | 6.4  | 9.3  | 5.5   | 4.9  |

Source: IMF (2009)

Mankind has always been going through the different crisis: religious, ethical, political or economic which leads to the conclusion that they are kind of rule. Crisis presents a state of heavy and light disturbances in economy and it exhibits as a crisis of insufficient production (scarcity) or excessive production (overproduction). Key explanation for crisis in real and financial sector is the fact that neoclassical economic theory has not accepted it and when they were painfully obvious, its answer was that they were inevitable and even useful (Kovac, 2009). Economists do not share the opinion that the crisis is true evidence of market inability and a sign of necessity that market should be suppressed as regulative structure in economy (Madzar, 2009). Recessions and crisis as phases of business cycles in real sector are mainly explained as imbalance in relations between macroeconomic indicators, but there is no explanation why imbalances in general appear. Because of fluctuations of business cycles, crisis is inevitable as well as business cycles are.

The latest crisis affected world economy and caused lower values of main macroeconomic aggregates such as GDP (Gross Domestic Product), investment, balance of payments, exchange rate (currency), foreign exchange, personal and government consumption, wages, employment, production and its capacities, demand. This is all a consequence of demobilization of resources which is caused by the market crisis (Bosnjak, 2010). It has confirmed three things: high interdependence of world economy, fragility of globalization process and a fact that market left to itself cannot guarantee realization of general interests (Dukic, 2010). We need more investments. The job of global financial markets should be to move savings from where there are surpluses to where they are needed. The markets failed in that role (Stiglitz, 2010b). The economic crisis of 2008 led to a loss in confidence in financial institutions and government more generally (Uslaner, 2010). Many major banks found that their positions were more than delicate and began to seek ways of redressing them. However, the crucial problem was that banks did not know which of their counterparts were in trouble and thus stopped lending to other banks (Kirman, 2010).

Application of the concept of neoliberalism becomes questionable and emphasizes the basis of Keynesian theory and return of welfare state. Krugman (2009) believes that we are living in a new era of depression economics. Keynes (1936) made sense of the Great Depression as now more relevant than ever and concluded his masterwork with a famous disquisition on the importance of economic ideas: Sooner or later, it is ideas, not vested interests, which are dangerous for good or evil. Keynesian economics presented us the tools and the intellectual framework so that today we can manage the consequences of a crisis better than we have done in the past (Stiglitz, 2010b).

Research hypothesis is: Global economic crisis, with its scope and dynamics, showed that current model of economic growth, based on neoliberal theory, was not adequate nor effective and productive and it required change of dominant theoretical and economic-political paradigm and implementation of new model of economic growth which would satisfy needs of modern global society.

### **3. Research Methodology**

The work is based on theoretical and empirical part. In the theoretical part of the work inductive and deductive methods, methods of analysis and synthesis, methods of qualitative analysis, descriptive and comparative methods were used. The theoretical part includes literature in the field of macroeconomics, business cycles, economic crisis, economic growth and development, economic theory, economic policy, economic policy instruments, neo-liberalism, Keynesian school, new theoretical paradigm, new development model. This type of research provides certain knowledge and proving the hypotheses in some way. In the empirical part, concrete examples of individual countries or groups of countries were used and their experiences with the economic crisis, economic theory and policy, economic growth and development, neo-liberalism and state interventionism, the new model of economic growth and new macroeconomic paradigm. The values of key macroeconomic variables are presented as well and considering them, we made conclusions and confirmed the hypothesis that the globalized

society requires a new economic and political paradigm and that the existing concept based on neoliberalism is not sustainable any longer.

#### 4. Research Findings

The crisis has shown how unregulated market can ruin capitalism as a system. Neoliberal doctrine had a negative impact on policy which helped crisis development. Negative thing is the opinion that market can regulate itself and that there is no need for state intervention and regulation. System without any aspect of regulation and control was unsustainable. Full liberalization or free market caused a lot of financial and currency crisis, including recent economic crisis. System could not withstand the crisis and its consequences and it showed that is unproductive and inefficient. It is called inefficient because of economic growth rate which was decreasing all the time and in 2008 the world faced with economic crisis and it brought a significant decline of GDP growth rate and increase of unemployment rate that can be seen in Table 2. One of the measurable indicators of economic crisis is reducing real GDP growth rate and it happened at the global level in 2009 compared to 2008 (-1.1), which is shown in Table 2. Except this indicator, unemployment rate is also relevant indicator of economic crisis (during 2009 unemployment rate at the global level was 6.6% and even 11.7% within the Eurozone). This is visible in Table 2 which presents trends of GDP growth rate and unemployment rate.

**Table 2. Trends of GDP-a and Unemployment Rate**

| Region                              | GDP (%) |      |      |       | Unemployment Rate (%) |      |      |      |
|-------------------------------------|---------|------|------|-------|-----------------------|------|------|------|
|                                     | 2006    | 2007 | 2008 | 2009  | 2006                  | 2007 | 2008 | 2009 |
| World                               | 5.1     | 5.2  | 3.0  | -1.1  | 6.0                   | 5.7  | 5.8  | 6.6  |
| Developed economies and EU          | 2.9     | 2.6  | 0.6  | -3.5  | 6.3                   | 5.7  | 6.0  | 8.4  |
| USA                                 | 2.7     | 2.1  | 0.4  | -2.7  | 4.6                   | 4.6  | 5.8  | 9.3  |
| Eurozone                            | 2.9     | 2.7  | 0.7  | -4.2  | 7.8                   | 7.5  | 7.6  | 11.7 |
| Great Britain                       | 2.9     | 2.6  | 0.7  | -4.4  | 5.4                   | 5.4  | 5.5  | 7.6  |
| Japan                               | 2.0     | 2.3  | -0.7 | -5.4  | 4.1                   | 3.8  | 4.0  | 5.4  |
| Australia                           | 2.8     | 4.0  | 2.4  | -0.7  | 4.9                   | 4.4  | 4.2  | 6.0  |
| Canada                              | 2.9     | 2.5  | 0.4  | -2.5  | 6.3                   | 6.0  | 6.2  | 8.3  |
| Central and Eastern Europe and CIS* | 7.9     | 7.6  | 4.5  | -6.5  | 9.0                   | 8.3  | 8.3  | 10.3 |
| Russia                              | 7.7     | 8.1  | 5.6  | -7.5  | 7.2                   | 6.4  | 8.4  | –    |
| Ukraine                             | 7.3     | 7.9  | 2.1  | -14.0 | –                     | –    | –    | –    |
| East Asia                           | 10.0    | 11.2 | 7.3  | 6.1   | 4.0                   | 3.8  | 4.3  | 4.4  |
| China                               | 11.6    | 13.0 | 9.0  | 8.5   | 4.1                   | 4.0  | 4.2  | -    |
| South Asia                          | 9.1     | 8.7  | 6.6  | 5.0   | 5.1                   | 5.0  | 4.8  | 5.1  |
| India                               | 5.5     | 6.3  | 6.1  | 4.0   | –                     | –    | –    | –    |
| Southeast Asia and Pacific          | 6.2     | 6.5  | 4.4  | 0.5   | 6.1                   | 5.4  | 5.3  | 5.6  |
| Latin America and Caribbean         | 5.7     | 5.7  | 4.2  | -2.5  | 7.4                   | 7.0  | 7.0  | 8.2  |
| Middle East                         | 5.5     | 6.1  | 4.9  | 1.4   | 9.5                   | 9.3  | 9.2  | 9.4  |
| North Africa                        | 6.1     | 5.8  | 5.5  | 3.7   | 10.4                  | 10.1 | 10.0 | 10.5 |
| Sub-Saharan Africa                  | 6.3     | 6.8  | 5.4  | 1.2   | 8.2                   | 8.0  | 8.0  | 8.2  |

Note: \*CIS: Commonwealth of Independent States

Source: IMF (2009)

Mentioned indicators and some others such as public debt in relation to GDP, level of world export, FDI flows and other macroeconomic aggregates show that neoliberal model was

powerless to confront the crisis and confirmed in that way its inadequacy and incompetence in giving answers to the challenges of the crisis. Table 3 selects one of the mentioned indicators, actually Foreign Direct Investment in some OECD countries. Looking at this data in Table 3, we can conclude that there are different fluctuations of FDI in those countries, which is result of many factors, such as economic policy of each country, position of the country at global level and impact of neoliberal model.

**Table 3. Foreign Direct Investment (FDI) in some OECD countries (millions of \$)**

| Country   | 2004   | 2005   | 2006   | 2007    | 2008    | 2009   | 2010   | 2011    |
|-----------|--------|--------|--------|---------|---------|--------|--------|---------|
| Australia | 39,625 | 28,223 | 26,331 | 41,475  | 46,687  | 31,668 | 37,665 | 59,753  |
| Belgium   | 43,583 | 34,351 | 58,926 | 93,448  | 19,3575 | 60,966 | 77,020 | 119,130 |
| Canada    | -445   | 25,693 | 59,765 | 116,809 | 61,520  | 22,733 | 28,399 | 39,667  |
| Chile     | 7,173  | 6,984  | 7,298  | 12,534  | 15,150  | 12,911 | 14,559 | 22,645  |
| Finland   | 2,828  | 4,747  | 7,656  | 12,455  | -1,142  | 718    | 7,359  | 2,552   |
| France    | 32,579 | 84,898 | 71,888 | 96,240  | 64,060  | 24,216 | 33,628 | 38,582  |
| Greece    | 2,103  | 623    | 5,358  | 2,112   | 4,490   | 2,435  | 330    | 1,144   |
| S. Korea  | 13,294 | 13,643 | 9,162  | 8,827   | 11,188  | 9,022  | 9,497  | 9,773   |
| Poland    | 12,898 | 10,299 | 19,599 | 23,582  | 14,833  | 12,936 | 13,879 | 20,652  |

Source: OECD (2012)

Neoliberalism is especially degraded by appearance of contemporary crisis because in its root were settings of neoclassical school and that is why role of the state must be emphasized in the future. The fact is that efficient solution cannot be made without active and rational government. For a long period of time, market was dominant in economic life, due to the neoliberalism and today role of the state cannot be neglected because the market cannot regulate itself. State intervention is inevitable which is confirmed by recent economic crisis which consequences neoliberal concept cannot eliminate. The same concept also shown as unfair because it could not provide the same opportunities for all; it is made a great gap between rich and poor which accelerated occurrence of economic crisis. Neoliberalism and globalization have given a contribution in making extremely rich on the one side and extremely poor on the other. Neoliberal concept, is a base for today's global system, is recognizable by growing differences in income and we can conclude that it is not sustainable and that it is really going through the crisis.

Achieving a critical point of inequality leads to the creation of economic crisis. Economic justice promotes economic efficiency. The state is much more effective in providing fairness. It is customary that during the crisis or after, there is a crisis of confidence in economic science and that is a reason for replacing a ruling theory with some new which should be generally more efficient. However, it is a question of how long that new theory will be acceptable and how long will succeed in a struggle against new business cycles and recession. The latest economic crisis strongly affected neoliberal economic doctrine and that is why today on a global economic scene, there is a conflict between neoliberal capitalism and state interventionism. It has been shown that followers of neoliberalism achieved at the same time extremely good political success and economic failure. During the last decades, the role of state in economy life was marginalized and today this fact must be changed because it is obviously that market cannot regulate itself. More and more attention is paid to the role of the state intervention within the Keynesianism in modern economic theory because the state can strongly affect duration of the crisis and its consequences.

It is interesting that during the time of crisis, everyone turns to the state and to the Keynesian theory but when situation is better, they all are back to its previous models forgetting the importance of state. It must not happen today, especially when there are some negative knowledges about neoliberal capitalism. State must get appropriate role in economic life which means that it should not be permeable only to the market. Macroeconomists hardly achieved consensus about the role of state and its economic policy which is not surprising because of the fact that mentioned role often changed during the history (it depends on theoretical bases). Economic crisis thoroughly has shaken bases of ruling theoretical paradigm and therefore

synthesis of a larger number of theoretical bases is required today and the result should be a new development model. All successful development models imply involvement in world economic flows, outlined mobility of work force, high rate of investment and saving, but also efficient governments which would react in case of need and be devoted to economic growth. Compatibility between market and state is very important as well as regulations of financial markets. Efficient growth model cannot be created easily but if there is quality strategy and resources, as well as government support, it is possible to build stable and sustainable model that suits everyone.

In the process of continuous changes, it is necessary to build more stable society which would be socially balanced and humane, primarily, and in accordance with ecological principles. There are plenty of demands and needs of global society and it is hard to achieve all of them, but we should not give up. Social balance in society, stability and achieving ecological principles can help in bringing about of Gross National Happiness (GNH) which should be a base for new development paradigm. Happiness does not mean only increasing of income and wealth, so it is not materially only and rich people are not the only ones who are happy although the money is very important assumption of happiness. Increase in consumption has its limits – there is a saturation at one level where happiness stops being an indicator of just economic welfare and takes some other form.

To achieve a concept of social welfare, it is not enough to possess and consume many products and to use all wanted services. Elements of personal pleasure are necessary the same as involvement of individuals in society that gives a feeling of acceptance. Only in case when people are happy, the concept of social welfare can be achieved and the welfare state can be built.

However, economists should reach a consensus about new theoretical paradigm and have confidence in it. This is the only way to make a new paradigm. It would not be clever to change unsuccessful paradigm with another that is unsuccessful, too. It is necessary to create new social-economic paradigm adjusted to the needs of global society and composed of liberal and antiliberal and capitalist and socialist elements. New development paradigm must promote welfare and happiness as a global goal and dynamic economic development. In globalization process, it is hard to assure equal life and work conditions for all, sustainable development and economic dynamism.

Economic policy of neoliberalism and its monetarist content must be abandoned. Appearance of economic crisis forced makers of economic policy to turn measures which will stimulate aggregate demand and it has shown that Keynesian countercyclical policy is current again. It is very important for state to become more flexible. Quality of economic policy means higher level of democracy and political stability. In addition to adequate and incentive economic policy, successful economic growth requires stability of financial markets and adequate compound of market and state. Growth should rely on innovation and knowledge as a key resource of economic success. Appearance of economic crisis mostly gives signals to the economic theory necessary to change current economic paradigm. Through the history, there were many different crisis but also many development paradigms based on different theoretical concepts. New development paradigm can be presented as a type of crisis management.

How long will it take to find a new paradigm, which should have economic and social elements? Is that new paradigm able to ensure fairness and efficiency, prosperity and happiness? Is it really going to be made by measures of modern globalized society, which needs change and increase every day? Considering only economic variables would not give long-term and effective decision and therefore, it is necessary to include social dimension also in process of making a new paradigm because the world is changing and developing constantly and that changes define our needs in final.

## **5. Conclusion**

It can be concluded that crisis is inevitability of capitalist way of production. It is a part of business cycles which phases of ups and downs periodically change. Economy cannot work perfectly all the time – it has some periods of negative trends of key macroeconomic indicators.

Transition of great number of countries and magnification of capitalism and liberal ideas created ideal environment for appearance and expansion of latest economic crisis. It brought state interventionism on economic scene again and repressed a concept of invisible hand. Neoliberal doctrine had a strong negative impact on policy which helped spread of the crisis. The system, in which each type of regulation and control was abolished, simply was unsustainable. Neoliberal concept was also unjust because it did not manage to give the same opportunities for all and it caused significant income distinctions. In process of continuous changes, it is necessary to build a stable society which is going to be humane and socially balanced.

Social balance in society, stability and fulfilment of ecological criteria can contribute to the realization of Gross National Happiness that should be a base for new development paradigm. Economic crisis of 2008 strongly affected neoliberal economic doctrine. When there is a gap between economic reality and current theoretical paradigm, it is necessary to create a new paradigm, and today it is social-economic paradigm adjusted to the needs of global society and consists of liberal and anti-liberal elements, capitalist and socialist elements.

The world economic crisis of 2008 is a key factor that should encourage fundamental reforms in the existing economic structures on the global scene. With its development and consequences, it indicates the unsustainability of market fundamentalism and return of state intervention. New social-economic paradigm is one of mentioned reforms and it requires many efforts to be achieved and applied in the global world. It should decrease the gap between the rich and the poor, make some positive changes and bring social welfare for people all over the world. New paradigm, based on Keynesian economics, should minimize consequences of some future economic and financial crisis, which are inevitable, but reaction of economic policy must be adequate and effective.

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