





# “Innovative ways of thinking concerning economic governance after the global financial crisis”

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# INNOVATIVE WAYS OF THINKING CONCERNING ECONOMIC GOVERNANCE AFTER THE GLOBAL FINANCIAL CRISIS

## Abstract

The global financial crisis highlighted the limitations of the mainstream economic thinking. The post-crisis reflection has not resulted yet in any new paradigm, however, several new, still separate, innovative approaches appeared in the field of public finances and economic governance. The aim of the paper is to provide a structured presentation of these new innovative approaches, which can serve as a potential basis of a new way of thinking about economic and financial governance and the innovation of public finances. The paper reviews the relevant international literature published after the global financial crisis and, as a result, presents the innovations, especially in respect of the role of the state, the renewal of central banking, the reassessment of the stability and geopolitical aspects of economic policy, the relevance of confidence and cooperation in public policy, the increasing role of the public sector concerning the sustainability of economic development and the renaissance of institutional economics. Based on these new approaches, the paper concludes that the smart, inclusive and sustainable, innovation-led growth requires the rethinking of the role, the functions, the objectives and the instruments of public policy and economic governance.

## Keywords

public administration, public policy, economics, crisis, paradigm

## JEL Classification

G18, A11, E00, H11

## INTRODUCTION

After the crisis that erupted in 2007–2008, a repository of a wide range of regulatory and supervisory interventions evolved, with the economic policy makers in the vanguard of seeking new methods (Godin, 2018). However, before a comprehensive theoretical and methodological renewal is achieved in economics, which provides the ideological basis for financial governance, and a new academic methodology is identified, the sustainability of the results may be called into question.

During the economic crises of the 20<sup>th</sup> century, we could witness intensive theoretical and methodological renewals in the field of social sciences, especially economics. To prevent even deeper economic recessions and simultaneously boost upturn, new economic paradigms were created. During the 1929–1933 global crisis, in his theses John Maynard Keynes laid the foundation of modern macroeconomics. A paradigm change of a similar magnitude took place at the turn of the 1980s, after the oil crisis. The theoretical framework of the neoclassical synthesis<sup>1</sup> had evolved at that time and lasted until the 2007–2008 collapse of the Anglo-Saxon mortgage markets.

1 Concerning the overview of the neoclassical synthesis see Romer (1993).

Since the mainstream neoclassical school<sup>2</sup> failed to prove any essential progress or to offer alternatives for decades, the crisis that set in during 2007–2008 can also be seen as a major “intellectual challenge” – and based on the experiences of the recent years, it also triggered substantial changes in economic thinking.

## 1. THEORETICAL BASIS

It is important however to note that there is no unanimity between the economists about the future of macroeconomics in general (Blanchard, 2018). Stiglitz (2018a) says that the mainstream macroeconomic models (DSGE models) – which have come to dominate macroeconomics during the past quarter-century – are inadequate and ill-suited for appropriate analysis, essentially because of the wrong microfoundations, which failed to incorporate key aspects of economic behavior. Reis (2018) thinks that many critiques of the state of macroeconomics are off target, even if it is true that macroeconomic forecasts perform quite poorly and too little investment is made in graduate-level textbooks. Krugman (2018) argues that while there was a failure to forecast the crisis, it was not because of a lack of understanding of possible mechanisms, or of a lack of data, but rather of a lack of attention to the right data.

This paper is based on the review on the relevant scientific literature, especially manuals, handbooks and scientific papers, which were published after the eruption of the global financial crisis in 2007–2008. We do not intend to summarize the state of macroeconomics and its potential developments. The main objective of this study is to present and assess in a structured way the most important novel approaches concerning economic governance and public finance thinking with special focus on:

- 1) the revaluation of the role of the state;
- 2) the renewal of central banking;
- 3) the reassessment of the stability and geopolitical aspects of economic policy;
- 4) the relevance of public confidence and cooperation between the state and the markets;

- 5) the increasing role of the state concerning the sustainability of economic development; and
- 6) the renaissance of institutional economics.

At the end of the paper we conclude.

## 2. RESULTS

### 2.1. The public sector in the process of value creation

The crisis has motivated the potential overwriting of numerous economic relationships. The one that has had the most widespread effect is that the crisis has clearly undermined confidence in market self-regulation and in the presumption that “the market always acts in public interest”. The recognition of the fact that economic recession and the market turmoil resulted from market dysfunctions, upset the quasi consensus that preceded the crisis and was based on the very assumption that state intervention in market processes was harmful as it gave no effect to market incentives. During the post-crisis period, countercyclical fiscal policy became an important tool (Blanchard, Dell’Ariccia, & Mauro, 2010), and it was revealed that fiscal multiplier was underestimated in the past (Auerbach & Gorodnichenko, 2012; Blanchard & Leigh, 2013; Ilzetzki, Mendoza, & Végh, 2011), meaning that the main pillar of the governmental non-interventionism was based on flawed assumptions. Pasichnyi (2017) examines the role of fiscal policy concerning economic growth from 2001 to 2015 and indicates the growing role of the state in social and economic processes.

Stiglitz (2012b) argues that healthy societies have strong governments and Adam Smith’s invisible hand ensuring that free markets lead to efficiency is invisible, at least in part, because “it is not there”. Gorton (2010) goes even further to the point of af-

<sup>2</sup> For more details about the evolution of “mainstream economics” see De Vroey and Pensieroso (2016).

firming that the global financial crisis has made the invisible hand only too perceptible: the world economy received a – hopefully sobering – slap from this hand.

According to Mazzucato (2018) – as cited in Kolozsi (2018) – after the experiences of the global financial crisis, it is “time to look at the state in a different way” compared to the pre-crisis period. Mainstream thinking treats government as a necessary evil, believing that the state can only remedy market failures (and only to a limited extent, because it can easily run into one of the government failures), and on the whole, government is not productive, and thus cannot create value. For Mazzucato this reasoning is false, because “in fact, the state plays an outstanding role in the operation of the market economy system as a whole, as well as in the development of markets, and in particular in the field of innovation and value creation” (Kolozsi, 2018). Free market does not mean a market free from the state, but a market free from rent, and state should not be small and stand in the background, but rather be proactive and courageous.

Another potential sign of change can be detected in the intellectual debate about “populism”, previously used as a kind of a pejorative swear word among economists. According to Rodrik (2018), there is a difference between political and economic populism. Economic populism may be justified, as in numerous cases “socially useless economic policy frameworks” do not serve the interests of the majority but protect the privileged positions of the beneficiaries of the previous economic regime.

## 2.2. “New normal” in central banking

The operation of central banks, constituting part of the state’s economic governance, has undergone a major transformation. In the pre-crisis period, monetary policy was rather single-minded. In their studies, Barro and Gordon (1983), on the one hand, and Kydland and Prescott (1977), on the other hand determined the basic frame in relation to central banks’ independence. More complex approaches – being more susceptible to realities – were put on hold till today, despite the fact that

already back in 1983, Woolley set up a typology of the factors having their effects felt through the government and those beyond the government, as well as the structural and the less embedded factors that may influence central banks’ decisions (Woolley, 1983).

Based on the practice of the world’s leading central banks, the former monetary policy consensus has been overridden by the crisis (Blanchard et al., 2012; Stiglitz, 2012a). According to Blanchard, Romer, Spence, and Stiglitz (2012), it turned out that:

- flexible inflation targeting does not necessarily create a stable monetary framework;
- it was unreasonable to narrow monetary policy (central banking) decision-making exclusively to shaping consumer prices;
- the zero lower bound (ZLB), considered as a merely theoretical limit for a long time, may be an important monetary policy problem;
- central bank’s balance sheets can be used as effective monetary policy tools;
- conventional and general instruments can be completed by unconventional and targeted measures;
- monetary and fiscal policies need to be managed in a coordinated way.

The real economic costs of financial instability and the resultant crisis may be considerably higher than the costs of a moderated inflation<sup>3</sup>. Before the crisis central banks focused essentially on short-term interest rates, but today it is generally accepted that other monetary policy factors can also affect macroeconomic developments, for example, concerning credit crunch and credit rationing. For this reason the post-crisis central banking models and strategies – with the expression of Reis (2018): “new conventional central banks” – frequently recommend the mixed and complementary, or even joint application of the different instruments, including micro- and mac-

<sup>3</sup> See the establishment of the Federal Reserve, which was not “justified” by an extensive price increase, but the 1907 collapse of the US banking sector and the following financial panic. Concerning the foundation of the Federal Reserve system see Tallman (2012).

ro-prudential tools. According to Stiglitz (2012a), these new (unconventional) monetary policy tools could even have been used to prevent the evolution of the credit bubble in the US housing market, which ultimately lead to the crisis – restricting market operation is less harmful and costs less than “cleaning up” after the crisis<sup>4</sup>.

Another aspect of that “new central banking” is that the mandate of central banks has been expanded – in the sense that central banks became more active in areas different from price stability, compared to the quasi passive pre-crisis period. Lentner, Szegedi, and Tatay (2018) underline that during the crisis management period, the social responsibility function of central banks has become also more prominent.

### 2.3. Stability and geopolitical aspects reassessed

Since the adoption of the Banking Act in the US in 1934 and the introduction of the deposit-insurance schemes, systemic financial and banking panic disappeared in the developed world. Regulated and monopolistic banking systems were set up. During these decades and essentially the Great Moderation (Giannone, Lenza, & Reichlin, 2008), the relative calm experienced in the markets was associated with the self-regulating mechanism of markets and not the impact of state regulation (Gorton, 2012). After the crisis it became clear that beside the 2-8 years long business cycles, the 14-16 years long financial cycles are also important, essentially from the point of view of financial and economic stability<sup>5</sup>.

As a crisis is always unpredictable and volatile, it is almost natural that during a stress period, stability is appreciated, and the reduction of vulnerability comes into focus. According to Taleb (2012), as the world is characterized by significant risks and limited predictability, the appropriate response is not to build as robust structures as possible, but the develop ‘anti-fragility’. Among the economic

causes of social vulnerability, Taleb and Treverton (2015) highlight excessive specialization, saying that comparative advantages not only increase efficiency, but also increase vulnerability. Society must prepare for the rapid and drastic changes in market conditions, as low-probability events can have serious repercussions (“black swans”, “tail risk events”). The same holds true to indebtedness and to financial systems characterized by high capital leverage: until the economy keeps expanding, no real costs appear, but when it is hit by recession, the different impacts reinforce each other. Taleb’s ideas may alter the very foundations of the general view of stability, sustainability and vulnerability, as he claims that the majority of the structures believed to be stable are only balanced on the surface, while the fundamentals are frequently wobbly, as a system is genuinely stable only if it is able to respond to shocks. In this respect, the operation of the public policy system is of outstanding significance, as adaptability often requires and means decision-making efficiency in the political sphere<sup>6</sup>. The crisis has rewritten the very bases of the propositions related to the economic sustainability of growth as well. Previously the basic condition of sustainability was that no inflationary pressure should evolve in the economy, while due to the promotion of efficiency, “financial deepening” was considered as a factor supporting long-term growth. However, the above described conditions lead to serious financial imbalances and the accumulation of huge debts. For this reason, in addition to the stable price environment, the definition of sustainability should also be completed with the operational stability of the financial system, and in addition to business cycles, financial cycles should also be taken into consideration for the assessment of the sustainability of growth.

It is also a fundamental change concerning public policy that geopolitical and geostrategic factors have been increasingly taken into consideration in economic thinking<sup>7</sup>. Geopolitics has been included in daily economic policy decisions for a long

4 About the “lean or clean” debate see White (2009).

5 For details about financial cycles and their behavioral aspects see De Grauwe (2012).

6 In line with that definition and approach of stability, Hanggraeni (2018) argues that in the banking sector – even if the impact of competition on bank fragility is conditional on the economic condition – in general more competition reduces bank fragility.

7 Recent cases of power politics such as China’s One Belt, One Road strategy, Venezuela’s petro-diplomacy during the era of Hugo Chávez and Western sanctions against Iran and Russia indicate that economic means have become critical to how states exert power. This shift in power politics is captured by geo-economics (see Kaplan, 2013; Scholvin & Wigell, 2018; Friedman, 2016).

time already, but the theory of economics is only beginning to re-discover that economic policy decisions and responses include more than purely economic arguments (geo-economics<sup>8</sup>). Although the sustainability of an economic policy decision may heavily depend on geopolitical impacts and consequences, traditional economic models have not considered these factors. In this respect, it can be justified to overview the entire flow of globalization, with special regard to the question if the current very fast spread of globalization is sustainable or not. Globalization has placed international coordination in focus, as certain (larger) countries trigger external impacts in the other (smaller) states by each single decision they make<sup>9</sup>.

### 2.4. Relevance of confidence and cooperation in public policy

In order to accomplish the economic policy objectives, a coherent and coordinated operation of the fiscal and monetary areas is required (Leeper, 1991). The crisis experiences confirmed that economic growth does depend not only on fiscal policy, but also on investment-boosting central bank schemes and on cheaper commercial bank loans triggered by low central bank base rates (Matolcsy & Palotai, 2016). After the 2007–2008 crisis, it became obvious that financial and economic policy can no longer be interpreted only within the framework of the government’s fiscal policy. In the years that followed the 2007–2008 crisis, the four main objectives which public authorities characteristically endeavor to orchestrate to achieve (economic growth, internal and external equilibrium, moderated inflation and ability to modernize the economy, the society and the institutional environment) could be accomplished with the intensive coordination of the government and the central bank.

A state able to build a cooperative relationship with its citizens, its business and banking sector, and with all other stakeholders, can be more successful than the one that is incapable of doing so (Kolozsi, Lentner, & Parragh, 2018). Based on

the extended conceptual model by Mandl, Dierx, and Ilzkovitz (2008), the output and outcome of economic policy actions can be substantially improved by the provision of incentives for the stakeholders, especially the market and other public participants (1) to make them interested in the success of state actions, (2) to make them identify themselves with the objectives of the particular state actions or programmes, and (3) to commit to achieving these objectives. As a precondition, this requires the reinforcement of the state, as only an efficient and powerful state is capable of “getting” the private sector to permanently cooperate. In a social perspective, the optimum is the “well-managed state”, representing cooperation between the state and its stakeholders, as both the cooperating parties and, indirectly, the entire society benefit from cooperation (Table 1.). Cooperation requires trust: Kolot and Herasymenko (2018) argue that trust is a fundamental phenomenon, a process of both socio-economic relations and the functioning of public institutions and permeates the entire spectrum of horizontal and vertical connections that are formed in society<sup>10</sup>.

**Table 1.** Cooperation matrix for the state and the stakeholders

Types of States	Cooperating partners	Non-cooperating partners
Cooperating state	“Well-managed, incentivizing state”	“Naive and exploited state”
Non-cooperating state	“State using up its own social basis”	“Non-cooperative, punishing state”

### 2.5. Increasing role for the state concerning the sustainability of economic development

According to the mainstream approach, the state’s role is merely confined to developing and maintaining the framework of market operation. Sachs (2014) recommends a new economic approach he has coined as sustainable development economics. According to Sachs, the neoclassical school misunderstands the role and nature of modern-age

8 For an insightful analysis of geoeconomics see Blackwill and Harris (2016), Troxel (2018), Salamin, Csizmadia, Gutpintér, and Simigh (2016).

9 See the quantitative easing program of the US, its tapering and the re-start of the tightening cycle, which has a major impact on the other leading economies, especially the emerging markets.

10 According to Akerlof and Shiller (2009), in the long run, one of the most destructive effects of the crisis was the lack of confidence between the participants of the economy regarding the future.

capital investments. In mainstream economics, prime significance is attached to private investments, investments bolstered and supported by low taxes and lenient regulation, or high demand. However, it should be noted that nowadays there is no private investment without government or community investment, the private and the public sectors are complementary to each other. The basis of private capital investments is public investment<sup>11</sup>, the quality of which is increasingly important, especially in two areas: in retaining labor and in power supply<sup>12</sup>.

A similar concept appears at Mazzucato (2015) who argues that nowadays countries are seeking smart, inclusive and sustainable, innovation-led growth, which “requires rethinking the role of government and public policy in the economy”. State is responsible not only for funding the innovation, “but also envisioning its direction and that requires a new justification of government intervention that goes beyond the usual one of fixing market failures and requires the shaping and creating of markets”.

The concept of “high-pressure economy” may also change economic thinking of sustainability to the core. That theory claims that recessions have permanently reduced the level of GDP (hysteresis) in two-thirds of the cases. The “high-pressure economy” concept comes from Okun (1973), but the concept was also underpinned by a 2016 survey (Fatás & Summers, 2016) who concluded that the GDP drop resulting from fiscal restriction also reduces potential output. The phenomenon of hysteresis appreciates counter-cyclical economic policy, as in addition to stabilizing the economy around the trend, fiscal and monetary policies may have a substantial impact on GDP over the long term (Dosi, Pereira, Roventini, & Virgillito, 2018)<sup>13</sup>.

Economics also stated to consider more and more the financing aspects of growth in a different perspective. The models based on external financing have been replaced by solutions relying on internal resources, as external financing may be attractive in the short term, but it may carry serious sustainability and renewal risks. In addition to their size and form, the utilization of the funds raised have come into focus, as burning through consumer loans have a different impact than the evolution of asset price bubbles or the financing of production capacities. The crisis has shown that the creditor-debtor relationship is complex, there is no ironclad rule, it is rather a regularly re-negotiated social “agreement” with the creditor involved just as much as the borrower and the community, i.e. the state (Skidelsky, 2014).

## 2.6. Institutions matter again

One of the major experiences of the global financial crisis was that economic models should be more realistic, as expressed by Kaldor (1972). This means, on the one hand, that it is time to exceed the classical “concept of man” in microeconomics<sup>14</sup>. The progress made in cognitive psychology started a new chapter and inspired economists to set up models built on a more sophisticated concept of human beings<sup>15</sup>, ultimately paving the way to the renewal of understanding macroeconomic correlations and the evolution and strengthening of an economic thinking that fits and maps reality.

Incorporating institutions into the models is also an important step in that context. The institutional background can be considered efficient if the various institutional levels are cascaded: formal rules fit to informal ones, written statutes to the community’s past experiences and cultural endowments, while the community is characterized by a high level of confidence and trust (about

11 In other words, infrastructure, roads, harbors, ports, the railway network, the public utility supply system, or the optical cables and education, on par with the society’s overall level of knowledge and culture, and the whole ecosystem, which make possible a high level of social confidence.

12 According to Gapper (2014), “cheap energy is the new cheap labor”. Energy price is of utmost significance for strategic industries like the chemical, the oil, the aluminum and the steel industry.

13 It is a general objection to the concept of high-pressure economy that it is risky in terms of inflation, but rise in the output has a decreasing impact on inflation.

14 To mention only the most obvious elements: (1) due to the limits of his cognitive abilities and the absence of information, we are unable to make rational decisions with a pinpoint accuracy (limited rationality); (2) in the overwhelming majority of cases, the parties involved are not identically informed and do not have identical knowledge (informational asymmetry); (3) people optimize for short term, i.e. they attribute less significance to long-term consequences than needed (myopia).

15 Essentially Amos Tversky, the Nobel Prize winner Daniel Kahneman, and Richard Thaler.

the significance of social trust in general, see Fukuyama, 1996). Regulation can be considered appropriate only if it respects local conditions. As formal regulation is the responsibility of political institutions, the precondition of efficient regulation is the establishment of a public political system that can convey the interests and preferences of the different social stakeholders to the various decision-making forums.

Mainstream economists typically think in terms of extreme solutions, leaving the solution of a problem to be solved by the market (through privatization) or the state (regulation). This wrong approach was interrupted by Elinor Ostrom who claimed that there were several solutions between two extreme solutions, as evidenced by numerous examples in community self-determination seen everywhere in daily life (Ostrom, 2009). The economic approach assuming a vacuum between individuals and the government is incorrect, as habits, social standards, personal relationships, and more or less formalized wider and narrower communities, voluntary organizations are all interposed between the two, and their existence and smooth operation are indispensable for economic development.

The increasing number of Nobel Prizes clearly shows that the rehabilitation of the once powerful institutional school has begun. There are, however, institutionalists who would not agree, as the appearance of the new institutionalist school has given way to the “critical institutionalist” school. Inspired, for the most part, by Veblen’s works (Veblen, 1898) and a book by Nelson and Winter

(1982), Hodgson (2016) claims that we should dismiss the view of the profit maximizing individual, as well as the invariable utility functions, which, with minor additions and supplements, constitute the foundation of modern economics.

### 3. DISCUSSION

Practice has cast doubt on the enforcement of the neoclassical synthesis underlying the crisis that erupted in 2007 in an unchanged form. This is reflected in the various efforts made at renewing economics (New Weather Institute, 2017). It is a fact, however, that a decade has passed, and the pre-crisis mainstream framework has not been replaced by a new, complex and coherent theory. This “theory deficit” and the resistance of the neoclassical school have an adverse impact on other social disciplines as well, especially on law, political science and sociology.

Thus, the decisions made to consolidate the economy have become ad hoc in nature and are forced to frequently adjust to regular changes in practice, the regulations do not demonstrate sufficient stability, for the most part due to the absence of theoretical foundations. According to Thomas Kuhn’s philosophy of science, before the establishment of a new paradigm, science continues to work with the existing one (Kuhn, 1962). However, the growing requirements concerning sustainability, stability, economic and social vulnerability call for a new paradigm in economics and essentially in economic governance and public finances.

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## CONCLUSION

“The theory of economics (...) is a method rather than a doctrine, an apparatus of the mind, a technique for thinking, which helps the possessor to draw correct conclusions” – said Keynes (1922), which even nowadays can be a compass for all economists. Economics must always adapt to the reality, and even if the theory cannot necessarily be a clear ‘yes’ or ‘no’ to specific policy suggestions, it can legitimately be expected to guide decision-makers properly and not narrow their focus more than necessary.

According to Stiglitz (2018b), the pillars of pre-crisis economic thinking were essentially not scientific models, but rather ideological foundations, all pointing in the same direction to reduce and minimize state involvement. The growth and apparent stability experienced at the beginning of the 2000s may have somewhat “comforted” economists, many of whom did not count on these factors. We had to wait until the 2007–2008 global financial crisis for the deficiencies of the mainstream economics to be clearly seen, and the crisis has led to the reconsideration of many dogma in economic theory (Lavoie, 2016).



Nowadays there is an increasing number of indications suggesting that the scope of economic thinking may widen and put special emphasis on the role of the state, the value added of cooperation, the significance of stability and sustainability taken in the broad sense of the words, the vulnerability to shocks and the importance of institutional frameworks. It goes too far to assume that these key words were completely missing in the period preceding the crisis, but certainly less attention was paid to these considerations before 2007. Fortunately, there is a good chance that in the future this will change. Ultimately, according to Hyun Song Shin (2013), macroeconomics “cannot remain insensitive to the facts forever”.

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