

ECONOMICS AND THE GLOBAL FINANCIAL CRISIS

Towards a Reconstruction

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ABSTRACT

This paper deals with the part that economics and economists have played in the current global financial crisis and the implications of the crisis for the future of the subject. It examines the practices in the financial markets that triggered the crisis, including subprime lending, securitization and transactions in derivatives, the role of the market system of economic organization in the behaviour of the financial markets, and the need to rethink economics as the world searches for solution to the crisis. It draws attention to some important aspects of economics that need to be re-examined, which include the teaching of the ideas that define the subject, the content and delivery of economics programmes in institutions, research agenda and methods, and the basic definition of the subject.

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1. Introduction

SINCE THE BEGINNING of the current global financial crisis, commentators have tended to blame economics and economists for it. The view is that the economic principles on which the global financial system was built have failed the world. And for this reason, some argue that economists 'can no longer faze laymen with their free market and market forces jargon' and must not be allowed the monopoly of economic matters.

The more perceptive of the commentators blame a particular brand of economics for the crisis. These contributors (Anup Shah, 2009; Krugman, 2009) blame the problem on 'current economics models' and the attitudes and approaches of their proponents—that is, the prevailing 'free market' economic doctrine that guides practices in most countries today and is preferred, supported and promoted by some of the powerful countries and international economic institutions. Shah (2009) argues that the global financial crisis 'could have been avoided if ideologues supporting the current economic models weren't so vocal, influential and inconsiderate of others' viewpoints and concerns'. He argues further that the financial crisis was the 'result of a system heavily grounded in bad theories, bad statistics, misunderstanding of probability and, ultimately, greed' (Shah, 2009:5).

Whatever readers think of this debate and the views that have been expressed, it is clear that the financial crisis has damaged the image of economics and economists, just as the Great Depression damaged the image of the then governing orthodoxy which, like the current orthodoxy, glorified the market while vilifying state action. The system and subsystems that man has built for the organization of the economic life of human societies and the world as a whole seem to have failed; hence, the ideas on which the system and subsystems were built and those who generated and propagated them cannot escape the blame.

The current crisis is thus an opportunity for economists to re-examine the ideas they have always propagated. This platform provided by the Nigerian Economic Society (NES) for rethinking economics is appropriate and quite commendable. This paper reviews the role of economics and economists in the crisis and the implications for the future of economics. The paper is organized into four sections. Section one is the introduction, while section two examines some of the immediate factors in the financial crisis. Section three examines the relationship between economics and the crisis, while section four offers ideas for consideration in the search for a way forward for economics and economists.

2. The Financial Crisis and How It Happened

The popular narrative about the current financial crisis is that it started from the collapse of the subprime market in the United States of America. The story is that, because of competitive pressures in the financial sub-sector of the American economy, subprime lending – the practice of giving loans to high-risk customers but at high (higher than prime) interest rates – became widespread. The banks

needed more people and institutions to lend to in order to meet their profit objectives; so they turned to high-risk borrowers in the belief that the high interest rates were enough compensation for the high risk of default. Unfortunately, as subprime lending grew, defaults soon emerged and grew. As this happened, losses mounted for the lending institutions and they had to curtail lending; some of them had difficulties meeting their obligations to depositors— those whose money was being lent out – and had to be bailed out by the government. The crisis spread to other countries as the affected institutions began to recall their loans to financial institutions and other business organizations in those other countries. Thus, countries with strong business connections with financial institutions in the US suffered the first-round effects of the crisis, while other countries came to be affected later through the normal processes of international trade, finance and investment.

Since the collapse of the subprime market in the US triggered the global financial crisis, one could conclude that the subprime market problems caused the global crisis. But this could also be superficial and misleading, as something else happened in the world of finance to stimulate practices, such as subprime lending, which was bound to create severe problems for the world economy someday. That other factor was ‘excesses of financial institutions’ in creating and using financial instruments, especially financial derivatives—such derivatives included financial futures’ contracts, options contracts, swap contracts and securitization. Of these, the most complicated, risky and dangerous to the financial system, the economy and the global society is securitization.

Securitization is the practice of raising funds by pooling various loans (loans that a lending institution has granted) into sellable assets and selling shares (securities) in the pool of loans to investors (i.e., shares in the pool of income-generating assets).¹ Securitization allows banks to pass on the risk in the loans they make to other economic agents and earn returns while doing so. This encourages banks to make more loans even to high-risk or subprime borrowers in order to have more loans to pool and sell to make even higher profits. Securitization thus permits a bank to create money on the basis of nothing and, by so doing,

¹ For more discussions on securitization, see: Brigham E.F., Gapenski L.C. and Ehrhardt M.C. (2001) *Financial Management: Theory and practice* (9th.ed.). Singapore: Harcourt Asia PTE; Kane A. and Marcus A.J. (1999). *Investments*. New York: McGraw-Hill Irwin.

undermine the effectiveness of monetary policy measures. Under a regime of liberal monetary policies, supervision and regulations, banks built what became a 'house of cards'.

Financial derivatives were created initially to help financial institutions raise needed funds for their operations. For some time, the devices served real needs in business financing, and were therefore useful in boosting production, promoting economic growth and development, and improving living standards. But over time, some greedy operators realized they could easily make money by trading in some of the devices, and speculation took over. This soon became the dominant activity in financial transactions, especially in international finance.

Speculation in financial derivatives is essentially gambling. It enables people to make enormous profits, often virtually out of nothing, within a short time. Sometimes, enormous losses are made. Where losses are made, the hope of recouping them induces the speculator to press on, so that he takes even more risks with others' money. He is restrained only by a major crisis, such as the one being experienced today. Heilbroner and Thurow (1998) stressed this feature of the system we have built in what they described as the transition 'from production to speculation' in capitalism, and warned about the effects of speculation on the behaviour of financial markets. They argued that 'financial markets can rise and fall with astonishing abruptness because they are driven largely by expectations of future prices, not by the conquest of actual markets. Hence ... financial booms can race heavenward and fall back to earth with dramatic suddenness' (Heilbroner and Thurow, 1998:222).

To a very large extent therefore, financial speculators are responsible for the current global financial crisis. They create this kind of problem from time to time (Toyo, 2001). It is worth recalling that speculators played a major role in the 1929 crash of stock prices on the New York Stock Exchange that spread an economic crisis to the rest of the world.² More recently in 1998 or thereabouts, they created a similar problem for some Asian countries and provoked protests from the leaders of these countries. Unfortunately, the world and, especially, international financial authorities, ignored the protests and blamed the Asian leaders instead for not managing their economies well.

² For a good account of the crisis, see Palmer, R.R., Colton, J., and Kramer, L. (2007). *A History of the Modern World* (10th ed.). New York: McGraw-Hill, 785-794.

But why do these crises happen? Why are some people able to gamble with others' money (the way financial institutions and organizations do) to create enormous problems for households, businesses, organizations, nations and the global community? The answers to these questions obviously lie in the set of rules that mainstream economics has prescribed to countries of the world for organizing their economic life—that is, the particular form of the private enterprise economic system or market system (as the proponents prefer to call their system) that neoclassical economics and its philosophers have imposed on the world. Although the collapse of the subprime market and the speculative use of financial derivatives by greedy individuals and organizations triggered the financial crisis, the root of the problem lies in the economic system—the brand of market system that has dominated the world in the last three decades or so. This type of economic system makes systemic crises, such as the Great Depression of the early 20th century and the global financial crisis of the early 21st century inevitable.

Economic system and the financial crisis

The events that brought about the current financial crisis were made possible by the preferred economic system. The rules of the system, especially those regarding minimal government and freedom of private resource owners to seek maximum private profits with their resources, created favourable conditions for crisis. Minimal government (i.e., the prescription that the role of the government in the economy be restricted to the control of money supply and maintenance of law and order) means deregulation of the economy, privatization of state-owned enterprises, and liberalization of trade, investment and financial transactions, including interest rate determination. These measures, which are a major part of the 'Washington Consensus', effectively weakened the influence of government in the economy and handed the system over to private profit seekers.

Financial liberalization, in particular, created conditions for massive speculative financial transactions and the other greedy practices of financial institutions, thereby triggering the current crisis. Subprime lending and trading in financial assets, including national currencies, occurred largely because of lax regulations resulting from the rule of 'minimal government'. Those who write financial contracts (on the derivatives) that are traded and those who transact business with them, often using others' money in their control, always know that enormous risks are involved; but because opportunities are there for making large

profits for themselves, and because the system permits them, they take the risk. When they succeed, they keep and use the profits the way they like, and the system continues. When they fail and losses occur, especially huge losses (as it happened recently), the system breaks down. It is therefore not enough to simply blame 'deep flaws in the functioning of financial markets' or lax regulations for the crisis, as some commentators have done, without examining the reasons for the apparent laxity.

With the collapse of the socialist systems in Central and Eastern Europe, beginning around 1989, and the emergence of the 'Washington Consensus' incidentally about the same time, most economists had thought they were never going to have to discuss the matter of economic systems again; that the debate was stale and over. This made philosophers of the 'preferred market system' and powerful nations and international institutions that supported the ideas, able and comfortable to resist and ignore any questioning of their system and, sometimes, to ridicule alternative viewpoints. They had no reason to contemplate change, except in the direction of even a greater market influence.

To reduce the chances of any real threat to their system, proponents of the preferred market system use their wealth and power to influence and control more minds around the world. They dictate research agenda for scholars, sponsor conferences, seminars and workshops for bureaucrats and policymakers, and influence the content, delivery and practice of economics.³ They struggle to justify their views and defend their system by showing that it is working; that it is producing and distributing desired goods and services, creating jobs for those able and willing to work, raising incomes, increasingly lifting families out of poverty, and improving living standards generally where it is 'allowed to work'. They manipulate data on some economies to prove their point and justify their actions. Budhoo (1990) provides an insider's account of such manipulations.

Thus, market fundamentalists appeared to be successful until now. The economic crisis, or meltdown, as some commentators prefer to describe it, has

³ For some of the most shocking stories of manipulations and abuse of economic concepts and methods, see Perkins J. (2006). *Confessions of an Economic Hit Man*. New York: PLUME (Penguin Group). It is noteworthy that Nigeria is mentioned in the book as one of the countries targeted for manipulation. Also see Toyo E (2001), for an account of the manipulations of LDCs by powerful capitalist countries and their agents.

exposed the failures that were presented as successes; it has destroyed the case for market fundamentalism. The crisis thus presents a great opportunity; an opportunity to free economics from the grips of the small but powerful group in the world who have used it over the years not to enlighten but to lead the general public to see things in ways that are favourable to them (that is, the group), the opportunity to reconstruct the subject for its original 'more scientific, expository purpose which is to seek to understand how things are' (Galbraith, 1975:23). Galbraith refers to this selfish and manipulative use of economics as the 'instrumental function of the subject', instrumental because it serves in the acquisition of power and the exercise of that power (Galbraith, 1975:19-25).

3. Reconstructing Economics.

This enormous task will have to start with a genuine attempt to help the public gain better understanding of economics and economists. Such a scheme will require that we go back to the very foundations of the subject and honestly explain what the concerns of the founding fathers were, the ideas that emerged from their reflections, and where disagreements brought about 'schools of thought' and competitions that generated 'intellectual strictures' and impeded understanding and genuine progress in economics (see Jameson and Wilber, 1979:1-36.)). It will also include a re-examination of the prescribed system of economic organization; of the content of our programmes; and of our methods, research agenda and even definitions of the subject.

A study of the history of economic thought helps students of economics appreciate how economics evolved and its deep philosophical roots. A course that helps students understand how the ideas that dominate economic thinking developed is critical to the training of economists. Yet the teaching of the course has not received the attention it deserves in many of our programmes. Many students still see the course as 'dry and difficult', and because of this, they struggle to pass their examinations and forget about the dry and difficult issues almost immediately after, which is unfortunate. There should be ways to stimulate the interest of students in the history of economic thought in view of its importance.

Among the core issues that should be stressed in the teaching of the history of economic thought are:

- the debates and ideas of physiocrats and the mercantilists about economic organization and the role of government,
- ethical values and foundations of human societies that Adam Smith discussed for some seventeen years (beginning in 1759) before his pronouncements on the private enterprise system of economic organization in the *Wealth of Nations* of 1776,
- the criticisms and protests of the pre-Marxist socialists (such as William Godwin, Henri de Saint-Simon, Robert Owen, Pierre Joseph Proudhon, among others) against the workings of the private enterprise system (especially the production of poverty and misery for workers and enormous wealth for entrepreneurs) which that great philosopher, Karl Marx, took up and stepped up,
- the attempt by neoclassical economists to respond to the socialist critics and defend the private enterprise system, including the introduction of devices designed to help convince or, sometimes, confuse and mislead their listeners and win the argument.

These issues will give students real insight into the causes of the crisis that has characterized neoclassical economics.

3.1 System of economic organization

A re-examination of the history of economic thought should lead naturally to the questioning of the system of economic organization that is prescribed by neoclassical economics, the system that market fundamentalists have imposed on the world. The key issue in this is the passive role assigned to government in the operation of the economy. Neoclassical economists, like the classical philosophers before them, believe that because of the corruption and inefficiency that characterize government activities, the economy would function better without government involvement. Hence, the proper and legitimate role of government would be to provide security of life and property so that private owners and controllers of economic resources can feel sufficiently safe to allocate their resources in ways that would yield the profits they want.

Recently, this role was extended by the more liberal-minded of the neoclassical thinkers to include government serving as a catalyst for the emergence of desired

business enterprises and as umpire for their operations. But what happens in societies that are so backward that there are no significant business operations warranting government playing the role of an umpire; societies such as we have in parts of Africa, where only the government can put together the required resources for initiating modern business enterprises of some significance? Would the dreaded corruption and inefficiencies that characterize government not affect the performance of its so-called proper and legitimate role – the provision of security – so that even though it is not directly involved in the economy, the effects of these inefficiencies would adversely affect overall system performance?

Why is it that problems of corruption and inefficiency in government are not being tackled? The constant refrain is that it is difficult; hence, government should be left out of the prescription for viable economic operations. Does this not amount to directly encouraging corruption and inefficiencies in government? Given the loss of confidence in the activities of some key segments of the private sector, as a result of the current crisis, and the widespread appeal to government to bail out the system, is it right to continue to ignore corruption and inefficiencies in government while hoping to successfully use the instrument of the state to overcome the crisis? It is obvious that economists must begin to give more attention to affairs of government than was hitherto given, as the crucial role of the state in the performance of the national economy is becoming increasingly clear. But this will require a review of the economic curriculum to include relevant course in government, and a further review of the content of the courses to ensure that they meet the needs of the time.

3.2 Content of economics

In the several aspects of the economics programme needing review, the part that needs urgent attention is that which emphasises efficiency and economic growth. Economists sometimes give the erroneous impression that efficiency and economic growth are the most important economic objectives; thus they encourage government to be satisfied with mere positive growth indices, even where the underlying data have been manipulated. In measuring and using growth indices, we seem to forget the warnings about what the conventional approaches leave out and the inappropriate use of growth indices to make statements about social wellbeing.

In addition to economic growth, economists need to emphasize the broader goal of development which takes into account unemployment, personal and regional inequalities, poverty, literacy, productive capacity, and the overall quality of life. In measuring growth, we must look more closely at the conventional procedures, taking account of the enormous activities that go on in the underground economy in the society, so that we can produce measures that are close to indicating what the economy actually produces and, therefore, the true living standard of the generality of people, which, in many cases, is more than the one dollar or two dollars a day that we have been associated with.

3.3 Economic research methods

The reconstruction of economics must include a re-examination of the methods of teaching the subject and of research. A lot has been said about this. Some years ago, this matter was a major theme of an annual conference of NES. But it is not clear that much has changed. The problem still remains the emphasis on quantification, especially the econometric procedure of regression, with the result that economic students often do not understand the recommended procedures; thus, the necessary interdisciplinary communication is impaired.

In research, emphasis on regression means that, in some cases, alternative research methods are not taught. Survey research techniques, in particular, seem not to have received sufficient attention in economics programmes. The evidence of this is the inability of many graduates of economics to develop survey research instruments or effectively participate in collaborative survey research. This weakness is bound to prove particularly costly for graduates who may wish to set up private practice.

There is not much to say about this problem by way of solution, except to remind ourselves of experts' advice on the need to select techniques according to the nature of problem being handled; to avoid fashion and be guided by relevance. It is, therefore, up to individual scholars; but we must be worried by the incessant complaints, by students, about the recommended methods and their inability to cope.

The point here is to look more closely at the things we do or encourage others to do in the name of research. With the current system collapse, this becomes obvious. As we struggle to build an economy that will truly sustain the society,

research emphasis must be on problems and issues that are truly relevant to the needs of the society. We must resist and reject externally-determined research agenda with little relevance to local needs and problems. We must move away from excessive focus on broad issues of monetary and fiscal policies and begin to show genuine interest in the many activities and problems of the various segments of the economy and society that need to be investigated and reported.

3.4 On the definition of economics

Most textbooks introduce economics as the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses; or any of the several variants of the definition. This definition by Lord Robbins (1932) has served the teaching of economics well because it emphasizes the problem of scarcity of resources which has become the *raison d'être* of economics. But the definition is an inadequate description of what most economists do today. Even though scarcity of economic resources is real, and the problem of allocating scarce resources is a major concern to economists, scarcity and the problem of allocation are not sufficient to define economics.

For some economic resources, such as labour, the problem is no longer that of scarcity, but of finding work for millions of people who are able and willing to work. And many economists today earn their living by talking about the problem of what to do with surplus labour, i.e. problem of unemployment. Yet, the work of these people would not qualify as economics by the popular definition of the subject. In the same way, the concern about the problem of inflation, which cannot easily be reduced to the problem of allocating scarce resources, would not qualify as economics.

An alternative definition of economics that seems more appropriate for introducing the subject is that it is: *the social science that deals with the analysis of material problems*. This simple definition appears in a not-often-cited textbook by James Willis and Martin Primack, published in 1977. The advantage of this definition is that it forces us to deal with the scientific status of economics early in the introduction. Also, it makes it clear right from the beginning that the subject is about analysis, and shows the difference between economics and other social science disciplines by stating that economists analyse material problems of human societies.

Conclusion

This paper has drawn attention to the role of economics in the current global financial crisis, and the need for major changes in the content, delivery, and practice of the subject. It also re-examined the definition of economics. The contested issues are many and no one person will or can produce the solutions. There will be disagreements in the contributions, but all of the views will have to be considered with openness, honesty and a determination to really reconstruct the subject if the desired change is to be achieved. The Nigerian Economic Society should use this opportunity of reconstruction to control and regulate the content of economics programmes in Nigerian universities so as to influence its delivery methods as well as establish its relevance in the nation's economic scene.

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