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Introductory remarks

The first volume of economic journal „Entrepreneurial Economy“ started to be published in 2002. Fifteen volumes, some of which had several issues, has been published until now.

This is the volume XVI.

The journal is published by the Foundation „Entrepreneurial Economy“ of the Postgraduate studies „Entrepreneurial Economy“ at the Faculty for International Economics, Finance and Business, University UDG, Montenegro.

The papers in this first issue of the volume XVI deal with the topic: **Globalization and Economic Crisis.**

All papers are written in English which is broadening the market of potential readers of this economic journal.

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Veselin Vukotic*

Philosophy of the history of the crisis

Abstract: *Prevailing approach which dominates science of economics today, and becomes axiomatic assumptions say: market is a imperfect mechanism, and as such it makes big mistakes. These mistakes of market are the main cause of the crisis. In order to prevent market from making mistakes, strong state regulation is needed. If the state regulates the market, i.e. if the state restrain unbridled market wild forces, the crises will not occur. This approach might be close to me once I was a student of economics with no experience. But, even then I didn't quite understand the explanation of Big economic crises, which was the result of hyperproduction – nobody could buy produced goods! Along with acquiring new knowledge and new experiences, this explanation of crisis remained unclear to me. I started to believe that wrong actors are accused to be responsible for the crisis. Today I firmly believe that the state provokes the crisis when disable the market to function naturally. As I intend to accept the challenge to prove this notion, this paper will precede one more comprehensive project aimed to do so. In the paper I'll keep the focus of my attention to two myths: myth of current economic crisis and myth of Big economic crisis.*

Key words: *Crisis, Interest (Rate), Market, Technology, The State, Central Bank*

Resümee: *Standpunkt das dominirt, und aufnimmt den Status eines Axioms ist: Der Markt ist ein imperfekter Mechanismus, die in ihrer funktion sehr großen Fehler macht und diese Fehler sind die Ursache der Krise! Das der Markt nicht so viele Fehler macht, sollte es von der seite des Staates reguliert werden. Wenn der Staat den Markt reguliert, oder die wilden kräfte der störung des Marktes zügeln, dann wurde es keine Krise geben. Vielleicht war das alles näher für mich als Wirtschaft Student ohne Erfahrung, aber auch damals war mir nicht eindeutig die Erklärung über die Große Wirtschaftskrise, die das Ergebnis der Überproduktion war - niemand konnte die hergestellten Waren kaufen! Wie ich praktisches erlangte und neues theoretisches Wissen, die Haltung über der ursachen der Krise wurden mir immer mehr unklar und unklarer und immer mehr habe ich angenommen die Philosophie das für die Krise der falsche Spieler belastet wurde. In der Tat heute bin ich der meinung das der Staat der verhindert das der Markt funktioniert, auf seiner natürliche waise die Ursache der Krise ist. Gerade die Herausforderung diese These zu beweisen hat mich motiviert, in einem umfassenden eingriff zu gehen, das nur eine Vorstufe zu diesem Artikel ist. Hier möchte ich zunächst auf zwei Mythen mich aufhalten: den Mythos von der aktuellen Wirtschaftskrise und der Mythos der Großen Wirtschaftskrise.*

Stich wörter: *Krise, Zinsen, der Markt, Technik, Staat, Zentralbank*

Резюме: *Мнение, которое доминирует и приобретает статус аксиомы, следующее: рынок несовершенный механизм, который в своей функциональности делает большие ошибки, и именно эти ошибки рынка являются причиной кризиса! Чтоб рынок не совершал ошибки, он должен регулироваться государством. Если*

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государство регулирует рынок, и внебиржевой рынок дикой силы, то кризиса не будет. Может быть, всё это мне было понятнее, когда был безопытным студентом экономики, но всё-таки не было чёткого объяснения Великого экономического кризиса, который стал результатом перепроизводства некому было покупать рыночные товары!

Со временем я усвоил практические и новые теоретические знания, и такое мнение о причинах кризиса для меня становилось все более непонятным, из-за чего понял, что в кризисе обвинили невинного игрока.

На самом деле, я считаю, что именно государство является причиной кризиса, предотвращая функционирование рынка своим природным способом. К стати, доказать этот тезис было вызвано стремлением идти в комплексный проект, которому данный текст является предшественницей. Здесь останавлюсь в первую очередь на двух мифах: миф нынешнего экономического кризиса и миф Великого экономического кризиса.

Ключевые слова: кризис, проценты, рынок, технология, государство, Центральный банк

1. The Idea Behind the Paper

During 2008 and 2009 I took active part at many conferences and seminar type events in Europe, USA and South America which focused the discussion on the financial and economic crisis. Many newspaper articles or professional economists' papers deal with the crisis. As an intellectual entrepreneur and the founder of private university I also have personal experience with the crisis. Of course, neither can I forget our Balkan crisis at the end of previous century, nor I can deny the fact that I belong to the generation who was educated on Marx's theory of crisis, as well as neo-Marxist theories such as Paul Sweezy's.

However, despite all of this, I cannot explain the essence of crisis with the arguments that prevails in scientific, professional and political public today.

The dominant point of view today, which is becoming axiomatic in many terms, says: **the market is imperfect mechanism**, which make failures and those failures cause the crisis! If we want to avoid those market failures, state must regulate the market. If the state regulates the market, then it will restrain the destructive power of wild market forces and the crisis will not occur. These arguments might have seemed closer to me, while I was a student, with no experience, but I remember that even then I didn't understand explanation of the Big Economic Crisis, which was the result of hyper-production – there were no consumers who would buy all goods produced! However, after I started to work, and while acquiring new knowledge and experiences, this viewpoint became completely unclear to me. I started to believe that the wrong subject is being „convicted as guilty“. That's why today I believe that

the state is really the one which disable natural functioning of market mechanism and thus the state cause the crisis. The challenge to prove this thesis made me write this paper, as the first step of one broader undertaking. In the paper, I'll keep my focus on two myths: the myth of contemporary economic crisis and the myth of the Big Economic Crisis.

2. Global Financial Crisis (2007 - ?)

2.1) Where Does This World Go?

United States of America, the cradle of the big crisis, lives in the hope that new elected President will solve all its problems. „We came to the end of economic liberalism – we are going back to the Keynes and the State!“ is the doctrine prevailing both in USA and Western Europe today. Some people are going even further and claim that we came to the end of capitalism and entered new system, which still have no name. „Where is this world going?“, with or without respect to the crisis – that is the question I don't want to answer. But, I'll quote Alexis de Tocqueville who answered this question in mid 19th century: „Honestly, I don't know the answer and I think it exceeds the power of our mind. The one thing is known – the old world is ending. Who will invent the new one? Even the greatest minds of the present day are not able to say what may be yet to come, as well as the greatest minds of classic time could not foresee the fall of slavery, rise of Christianity, barbarian invasion – the events which changed the face of the Earth.“¹

That is the reason I am not brave enough to foresee the future of the world, no matter for the fact it is clear to so many people and is related to Obama, IMF, etc.

„Haven't we come to the conclusion that modern society needs managers 'who know everything', not philosophers who 'know nothing'?“ (S. Reljić, NIN, 3041)

Maybe this explains the reason to put the word „philosophy“ in the title of the paper.

2.2. The Necessity of Changes

After capital market fell in 2008, companies faced the problems; uncertainty and economic difficulties spread over USA and global markets, one refrain can be heard everywhere: „The market economy has failed! The change is needed!“.

¹ De Tocqueville, A. (2002) „*O demokratiji u Americi* (translation of *On the Democracy in America*)“, Sremski Karlovci, pp.45.

According to Obama, late Bush administration, both Republicans and Democrats in Congress, as well as many foreign elites and media, the solution of this problem is to strengthen regulation, increase spending, create new money, and increase debts...

More regulation, more subsidies, more state – this is the essence of the philosophy promoted by G-20, which is the strongest group of world capitalists.²

They discuss the desirable solutions! But, whose **interests** are being protected through the solutions, which are proposed? Maybe it is the reason why nobody asks the question: “Where has the crisis come from?” The common answer say: it comes from unpaid house loans. But, why these loans were not paid? ...Because the banks were giving loans to people who couldn’t pay it back. Why did the banks give the loans easily and with no collateral? The answer to this question is the main crossroad in understanding today’s crisis and its philosophy!

„The greed is the crucial reason for this situation“ – the greed of banks and the greed of loan users!³

Without the intention to enter these discussions, I agree with the group of economists who claim that accusing greed for the crisis is as same as if we would accuse the gravitation force for the plane crashes.

In this paper I’ll give the arguments which explain the causes of growing „*household bubble*“. In order to do so, I’ll use some papers from the Mont Pelerin Society meeting held in New York in March 2009 and Association of Private Enterprise Education (APEE) held in Guatemala City in April 2009, as well as contemporary literature on this issue.

2.3. Who Created the „Household Bubble“ – the State or the Market?

Almost everybody remembers the advice that investment in the house (real estate) is the most certain, because the value of the house cannot fall. This was the starting point of the policy implemented by many states, so called policy of “ownership society”, which means that majority of citizens should own something. That’s why these states provided cheap loans. Cheap loans caused the appreciation of real estate prices, especially in USA. The real estate prices started to fall at the end of 2006. It generated the problem how to pay back the loan: while real estate prices were growing the owner could sell the house and pay back the loan; however, when prices started to fall – it was no longer possible. Banks were facing severe difficulties! At the same time, the banks started to create new financial instruments: “attractively

² Kennedy, P. (2009): „*Karl Marx and the G-20*“, International Herald Tribune, April 2nd

³ Sen, A. (2008): „*Capitalism Beyond the Crisis*“, The New York Review, February 25th

packed suspicious loans” and to sell it on the secondary loans market through Fannie Mae (I’ll explain the establishment and the role of this institution later in the paper). This contributed to the risk diversification, as „mortgage-backed securities“ were involved in the revenue generated from real estate business around USA. The logic behind this is that, if prices are falling in one state, it’ll be compensated by high revenues from the other states. But the problem occurred once prices started to fall everywhere in USA. Buyers of „mortgage-backed securities“, such as foreign banks, institutional investors, especially those from China and Western Europe, got into troubles.

At the same time, risk rating agencies ranked mortgage-backed securities with AAA in most cases - they were almost treated as risk-free securities and it just encouraged many to invest in it.

Should we accuse the greed for this price-growing spiral? Or should we just look for the answer to the question: **where did so much money for giving cheap bank-loans come from?** Which institutional mechanism enables giving cheap loans? Was this money created by the market? Or may it be the result of state intervention and the decisions made in the public administration?

From this point of view – crucial mistakes made by the state are as follows:

- a) Two bodies which had been in the center of the market crash were Federal National Mortgage Association – Fannie Mae and Federal Home Loans Mortgage Corporation – Freddie Mac. These Leviathan corporations were created by Congress and they are officially known as GSC, which stands for Government Sponsored Corporations. These organizations were buying loans from banks and thus created „secondary credit market“. After selling the loans, banks didn’t keep the information on these loans in their balance sheets. Fannie Mae and Freddie Mac became responsible for the loans, which citizens were taking from banks and they were selling it to the investors, mostly to international investor, from outside of USA. The banks used the money from Fannie Mae and Freddie Mac as the base for giving new loans. That generated spiral of new credit activity, now artificially created. The truth was that the GSC had special sponsorship by the state. The securities of these two corporations were known as the “state securities” (although these organizations were privatized in 1970, they stayed in close relation to the government and politics). The GSCs were used to implement the White House supported policy of so-called “ownership democracy” through giving easy and cheap house loans. Back in 1999, New York Times warned on the danger of interventions of these two corporations in the real estate market. The issue was also discussed in the

Congress. For example, in September 2003 Texas congressman Ron Paul spoke about the destructive impact of Fannie Mae and Freddie Mac on US economy.

“The special privileges, granted to Fannie Mae and Freddie Mac, have distorted the housing market, allowing them to attract capital they could not attract under pure market conditions. As a result, capital is diverted from most productive use, into housing. That’s how the state create short-term boom in housing”⁴

Despite this, Congress continued to promote and give support to these corporations!

- b) Many state institutions encouraged banks to give higher risk loans in order to prevent “racial inequality”. A study conducted by Federal Reserve Bank from Boston in 1992 “accused” American banks for discriminating “non-white” people. This study was the reason to enact so called Community Reinvestment Act (CRA), which banned the discrimination of this kind. It automatically meant that implementation of the CRA promoted giving easier and higher-risk loans.
- c) The state stimulated speculating activities directly or indirectly. Loans approved out of strict banking standards, as well as low level of Federal Reserve’s interest rates influenced the rise of real estate (houses), and thus attracted people to speculative transactions (buy today – sell at the higher price tomorrow). Rating agencies also fell under attack of this euphoria and prevented the true perception of reality.
- d) Tax system encouraged buying houses from 1997. For example, the tax on capital gain earned in housing trade transaction was abolished.
- e) Low level of FED’s interest rates caused business cycles and crisis. When Federal Reserve reduced interest rates through increased money supply, it influenced the production boom, i.e. long-term projects in production of raw materials, construction and capital projects in general. The good example to illustrate this influence of low interest rates is to explain how it generated the boom of construction industry in previous decade. Low interest rates distort consumers’ real preferences, as well as the perception of real level of savings. Savings are artificially directed into essentially non-sustainable projects. This non-sustainability becomes visible and the prices started to drop, and the owners of new houses, with no real savings and with loan liabilities face the problems. All of this happens in the period 2000-2007, when the dollars were printed heavily and money supply increased by the highest year rate in history.

⁴ According to Woods, T.E. (2009) „*Meltdown*“, Regency Publishing, Washington, DC, pp.71

- f) Many see the lack of banking regulations as the crucial cause of the crisis. Financial deregulation brought us into the crisis – this was often emphasized during electoral campaign of the President Obama. However, many researcher argue that people acted in the way federal administration and central bank wanted. In 2004 President Bush said: „We must help American citizens to buy houses. That’s why these 150.000 houses must be bought without giving any down-payment when taking the house loan!“.⁵ Several economists warned that this policy might cause the real estate market bubble, and one FED’s expert group answered through the research, which claimed that this policy wouldn’t cause the housing bubble. Alan Greenspen claimed this as well, which means that the measures of the regulators encouraged the desired behavior at the real estate market.
- g) Many responsible people and institutions in USA believed that US economy is too big and too strong to fail and to get into crisis. Alan Greenspen was one of these people. The policy he implemented, especially after September 11th 2001, made the investors give him a nickname “Mr. Bailout”. This self-confidence encouraged expansive monetary policy.

The arguments I explain above have one goal – I want to make people, who accuse the market in advance and see the solution in active government policy, to re-thing these issues and to ask themselves whether **the market failures are caused by the distortion of market** or they are created by state; I want to made them to wonder whether causes of the crisis come from **the government failures indeed?**

3. Is the State the Problem or the Solution?

3.1 The Course of the Crisis

The bubble moved from real estate market to Wall Street, even though officials were not publically speaking that this might happen. For example, Henry Polson, Secretary of the Treasury said in March 2007, that “it seems that US and global economy are the strongest in his business carrier”. One year later (in March 2008) he said that “our financial institutions are very strong and stable. Our banks are strong. They are strong and stable in long-term period!”⁶

In May 2007, when the break of real estate market started, Ben Bernarke, The Chairman of Federal Reserve said: „We don’t expect that problems from real estate markets will transfer to the economy overall or to the whole financial system.“

⁵Woods, Thomas (2009): „*Meltdown*“, Regnery Publishing, Washington DC, 2009

⁶ IBID, pp.27

US economic reality, however, went in the opposite direction. Wall Street investment bank, "Bear Stearns" bankrupted in March 2008. This bankruptcy influenced JP Morgan, the other investment bank, which borrowed money from FED. That's when FED, with no single vote against, decided to buy "Bear Stearns" and to merge it to JP Morgan.

In August 2008 Polson and Bernanke started to pursue US nation that the help of Fannie Mae and Freddie Mac are necessary in order to keep the health of US economy! „Don't panic! Don't stop the investments! Don't stop house loans...“ They were lending money from FED and Treasury to banks... But, these warnings just spread the panics!

Struggle against panics just strengthen the logics of justifying bailouts. In early September 2008 Secretary Polson announced that the Government will take over Fannie Mae and Freddie Mac, which made 75% of US secondary real estate market.

Despite the fact that this was the "school example" of nationalization, the act was named „conservatorship“.

Things went in wrong direction and nothing could stop them. At the end of September 2008, Bank of America bought Meryl Lynch. Soon after that the bank Lehman Brothers bankrupted (assets of \$639 billion and 26000 employees), a FED injected \$85 billion into the failing ING. Billions of US dollars are injected into financial system in order to save banks and Wall Street actors.

Opinion that the big ones cannot fail was still dominant: thus Fannie Mae and Freddie Mac continued to help and protect parasite sectors in economy.

At the end of September 2008 Bush administration realized that the economy needed much more funds in order to survive. That was the reason to prepare comprehensive program aimed to help economic recovery. It was so called Emergency Economic Stabilization Act of 2008, containing 442 pages and authorized by Treasury. This stimulation package was \$700 billion worth. The practice has already shown that this amount was not big enough to overcome the crisis (the amount of \$3200 billion is mentioned as the solution). It was the start of „bonanza“ of the state support, i.e. the losses of companies were covered from the budget (taxes paid by citizens and companies). Thus the losses were socialized. The belief in recovery support packages and the power of state to solve the problem (which was also created by state) was strong and is still very strong.

However, USA got into recession. Thus average price at US housing market, which experienced 150% increase in the period 1998-2006, dropped 23% in 2007-2008. On

October 9th 2007 Dow Jones Industrial Average reached the highest value ever - 14.164,73 points. On November 20th 2008, after thirteen months, the value of the same index was 7552,29, i.e. it was reduced 46,7%. Economy faced growing unemployment – in November 2008 unemployment rate was 6,7%... But if the data on unemployment would have been calculated using old methodology, used until 1970, unemployment rate would have been 16,7%...⁷

Unemployment caused many personal troubles. Ordinary people faced serious problems. That was exactly the environment which justified state interventions and the need of the state to create “social buffer” and “social network”. Are you even allowed to contradict such goals?

Was it the wrong way to fight against crisis? Is it possible that we wrongly accused the market for the occurrence of crisis? Is market behavior prior to the crisis the result of implementing free market rules, or state administration decisions? This is not just an academic question, neither in Montenegro, Serbia nor in US. It is the essential question of many people around the world today. The supporters of state interventionism promised that “market failures will stop” after first packages of help were put in function, and thus “the state will solve the problems”. However, if the state really wants to fix the problems, it has to identify the real causes of business cycles.

What are the causes of business cycles? What were the causes of this crisis?

It seems that reasons, which are dominantly considered to be main causes of the crisis (wild capitalism, greed, deregulation), were not the real causes, but the crisis was caused by the state and its behavior; the main cause of the crisis was the interest of bureaucracy in the national states around the world to keep their business of redistribution going - redistribution means taking money from those who create value, giving it to those who don't create value, and charging high provisions for the service (budget).

3.2. The Cluster of State Errors and the Free Market

Indisputably, businesses make mistakes. For example, we can make bad estimates of demand; it is possible to make mistake in business concept; business can rely on wrong technology; sometimes, the production result in lower quality products and services, etc. All of these mistakes lead business into problems, and consequently into bankruptcy. Bankruptcy is regular event in the real world of market economy.

⁷ According to Woods, T.E. (2009) „*Meltdown*“, pp.45

However, if most businesses make the same or similar mistakes in the same time sequence, then few questions arise: **Why do every business make mistakes? Why all of them make the same or, at least, similar mistake?**

The truth is that the loss of a company is really the matter of that company! But, why does it happen that almost all companies are making losses?

British economist Lionel Robbins was trying to prove that the “cluster of errors” (i.e. bundle of errors) need to be scientifically explained. Lionel Robbins asked: „Why did business from different industries make mistakes in estimating market prospects at the same time?“. ⁸ This pattern of businesses’ behavior is widely known as the business cycle, the trade cycle, or the boom-bust cycle.

Does the real cause of business cycle lie, as Carl Marx was claiming, in features i.e. in nature of market economy? This Marx’s claim was the starting point of all platforms against crisis implemented around the world. Electoral campaign of President Obama was shaped on such platform – deregulation and (free) market are blamed to be causes of crisis occurrence and spread, and common state driven solutions are proposed to fix the problems.

The fact is, that if we want to be sure we can fix the problem of business cycles, we need to know how was it created, and what are the driving forces behind it.

Friedrich Hayek has got Nobel Prize in 1974 for his contribution to the development of business cycles theory. Hayekian theory of business cycles was further developed by one more Austrian economist, Ludvig von Mises. His answer is: **business cycles, business collapses are caused by Central bank.** In the US case, that is Federal Reserve. But, today Federal Reserve and other central bank authorities declare themselves to be the protector from crisis and the cure from business cycles, don’t they? FED has the power to increase and reduce money supply. The level of money supply determines the level of interest rate. Interest rates, similar to the price of any other commodity, depend on the supply and the demand. The truth is that interest rates are the prices of very specific commodity – the price of money, but money supply and money demand determine the price of money – it is what we call the interest rate.

If we analyze the level and trends of money supply we can identify the causes of the fact that **all business are facing crisis at the same time.**

If households have more savings, then the banks will be able to give more loans, because interest rates are going down (more savings = more money). But, if it

⁸ Robbins, L.(2001): „*History of Economic Thought*“, London

generates the race for loans, it will push money demand up and interest rate will automatically rise.

That is explanation of trends at the free market, where supply and demand determine prices. Despite difficulties, this process leads economy to “healthier” and the most efficient outcomes.

How can we explain the functioning of free market mechanism which leads to sustainable “health” of economy and the most efficient outcomes in long term?

We go from the same starting point: households have more savings (more money in banks), and it increase money supply (more money is circulating in the economy), but it also increases the amount of money available for loans (credit activity). Higher supply always pushes the price down – in this case it influence reduction of interest rate. What does this mean from the business perspective? Lower interest rates are giving an entrepreneur (or a business) the possibility to think about investments into long-term projects, which couldn't be realized if interest rates were high.

Businesses use the low level of interest rates to invest into production, either through expansion of existing, building new production capacities, or buying new equipment. That is the way to increase the level of production or profits.

Let's analyze the implication of this situation on savings. The level of savings indicates relative importance of the desire to spend money now and satisfy the current needs with respect to the desire to postpone its spending for the future. This is an additional motive to invest in future, in realization of projects which seek longer term prospects, as we have higher preferences to future production (in comparison to the current).

In other words, if households **prefer to spend money today**, then they will **save less** and interest rates will grow. This will influence the businesses to take less loans, and as a rule, to use it for producing goods which will be consumed in short-term prospect. Long-term projects come into question. Increased money supply, i.e. increased level of consumption at the markets means favorable situation **to produce and sell now**.

This explains the fact that the level of interest rates **coordinates the level of production in the time**. The level of interest rates ensures compatible mix of market forces if households want to spend in present time; if population wants to spend in the future, however, the level of interest rates influence business to allocate resources so as it can satisfy the future preferences. Companies cannot invest in the

development resources for the future (new production capacities and equipment), if consumers prefer spending in present time.

3.3 Central Bank and Its Role in Generating Crisis

What is going on when Central bank, as the money printing authority, intervenes in the situation described above?

When Central bank, FED in US case, start to **manipulate** with the level of interest rates (changing it independently from free-market logics), then we should not be surprised by uncoordinated economic activity at large scale. Central banks have many ways to manipulate the level of interest rates! What happens if Central bank is following the policy of low interest rates? In free-market setting low level of interest rates indicate rise of household savings. But, if Central bank holds interest rates artificially low, their level is no more the reflection of real economic conditions, i.e. it is not the indicator of the real demand and savings of consumers. Households didn't increase their savings, so it clearly shows that they have no desire to spend less today. Artificially low interest rate gives **wrong signal to investors**. They invest into project which would be non-profitable in real economic conditions. It opens a door of irrational (non-economic) thinking, which de-stabilizes whole economy. The policy of low interest rates, which FED was promoting for very long time, made investors to think that **today is the right time to invest money in projects with long-term prospects**. However, there was no indication that households will postpone current consumption (and thus save more) for the future, and this is exactly the philosophy long-term projects should rely on.

Low level of interest rates, as the result of Central bank manipulations, makes the confusion in functioning of the markets and market forces. It interrupts the coordination of production level in time. Long-term investments can bring return only in future, and, if interest rates are kept low, long-term projects are encouraged in the situation when households are satisfied with the level of their spending and consequently households doesn't increase savings. In addition to that, low level of interest rates stimulates households to spend today more than they would spend otherwise (if interest rates were higher), i.e. low interest rates don't give households incentives to save. That moves the trigger of the crisis in the situation when Central bank follows the policy of artificially low level of interest rates: **low level of interest rates stimulates households to save less, and spend more and give incentives to long-term investment projects!** Investments into long-term projects, if they are not based on savings (as the source to finance long-term project) will necessarily result in crises, sooner or later. Mises compared this situation to the one when a man wants to build a big house with a small number of bricks. Building the house is a long-term project, and the number of bricks is the level of savings. If we started to

build the house irrespectively big to the number of bricks we have, then the crisis will reduce the house to its real size. That's why we say that the crisis is bringing us back into reality!

3.3 What Can We Learn From the Great Depression And Other Crisis From the Past?

The break of the free market as the main cause of the Great Depression and the New Deal, as the solution to the crisis (i.e. so called state capitalism) are two myths which form the base for globally prevailing economic and political thought related to the crisis.⁹

Large scale of today's literature analyzes the Great Depression from this time distance. I want to recommend two of them: Ben Bernanke "Essays on the Great Depression" (2000) and Roberta Higgs „Depression, war and cold war“ (translated in Zagreb, 2007). However, it's very important to use results of many researches to point out important facts about the existence and the real nature of crisis, the real nature of FED and the reasoning behind its establishment (1913.godine).

Back in 1819 (at the time of de Tocqueville stay in US) panics overwhelmed US markets. The panics originated from the fact that US banks printed more paper money then they had covered by gold in their deposits. The assumption is that the paper money can always be exchanged for gold at certain price. As the banks printed more paper money, the value of that paper money (measured by the volume of goods that can be bought for that money) started to fall and that caused the panics in the whole economy.

Similar thing happens during 1830's, and inflation rates reached high levels.¹⁰

Loans and credit activities of banks, artificially driven, brought the economy into very difficult position.

⁹ I was educated on this myth. I believed in it. The first time I became a member of the Government of Montenegro (1985) made me rethink about this myth, shaken my belief, and I started to doubt and requestion it – this gave me completely different view on the proplem of the crisis. In addition to that, as a student I started to read, at the time, banned books such as „*The Great Contraction 1929-1933*“ written by Milton Friedman i Ana Swartz. I also started to explore literature and authors from the Austrian School of economics. All of that shaped the opinion on the crisis I have today.

¹⁰ The opinion of economists from the time about the consequences of the sudden inflation and weakening money were very interesting (William Leggett). Business is stimulated to get into wrong and economically „sick“ activities, large share of production was based on the tricks and the fraud, many speculations with property ended with the crisis, which made the economy unstable... „Many people went to bed rich, and woke up poor... Anybody could see that the banks were using tricks to sell the papers they issued to people (money banknotes and securities) and suddenly the economy was overwhelmed with such „papers“.“

The crisis that occurred in 1857 was also the result of credit expansion.

But, the problems were solved through adaptation of behavior of market actors and sometimes bankruptcy of banks and companies.

Economic historians also mention the crisis from 1920, after the First World War. This crisis occurred just 7-8 years after FED was established. US authorities chose not to intervene at the markets to solve the crisis. They left market mechanism to work and market actors to adapt to the new conditions. On the other side of the world, Japan, tried to solve the same crisis through introduction of planned economy. This attempt resulted in economic disaster, which brought Japan to its national-socialism and Second World War.

I felt the need to mention these crises from 19th century, as their causes were always the result of state interference into market activities. Actually, the state was endangering the logics of free markets, by printing more money, but the solution lied in adaptation of behavior of market actors.

The Great Depression has preceding history in the years 1920-29. FED maintained inflationary policy in that period. The level of production rapidly grew in all industries in the period 1922-1927 (automotive industry 4,2%; production of oil 12,6%; industrial goods 4%; raw materials 2,5%). Why didn't this growth of supply result in the price decrease? The question is why prices didn't fall?

The explanation lies in money supply. In the period between 1921 and 1929 the money supply grew by 55%, or by average yearly rate of 7,3%.¹¹ But the amount of currency which circulated in the economy was not changing. The money supply grew due to increase of the total amount of credits (loans) in the economy.

Given loans were encouraging businesses to invest into long-term projects, i.e. into production of capital goods. As the value of firm, represented through the price of its shares at the capital market, depend on the value of capital goods, all of this influenced growth of shares'... This further stimulated growth of real estate prices. As Friedman said, people thought that 1920's are the eternal end of business cycle, similar to the claim that the end of First World War was the end of all wars ever.

The leading economist of the time, and one of founders of what we call mainstream economics today, Irving Fisher thought that the prices were stabilized on long-term and that US economy is entering the upward phase. Only two months before the

¹¹ Data according to: Ben Bernanke „Essays on the Great Depression“ (pp.14, 15, 16)

Wall Street break, Fisher wrote that shares' prices can experience a slight drop, but he didn't think of the possibility of complete market crash!

However, Austrian economist Ludwig von Mises claimed that inflationary boom will unavoidably end in the market break and the break of the economy. „Permanent prosperity is the fantasy of mainstream economists. It is completely clear that the crisis will occur sooner or later. It's also clear that the crisis is always caused, directly or indirectly through changes in managing banks, i.e. FED's mistakes “. ¹²

Collection of such mistakes led to the crash of capital market in October 1929. The crisis reached its peak in 1931, which was known as “the tragic year”. Sharp decline in the production level and the rise of unemployment overwhelmed first US, and later world economy.

What was the reaction on crisis?

Contrary to proposals of Austrian economics, the US President at the time, Herbert Hoover, who claimed to be the supporter of laissez-faire capitalism, said that the laissez-faire approach had died indeed. Hoover was the first US President who introduced strong protectionist measures, such as the tax increase, public works, measures aimed to limit and reduce international trade, recovery projects were financed through borrowings. Frank Roosevelt criticized high level of public spending of Hoover's administration in his Presidential campaign and Hoover's tendency to centralize the administration in Washington. Although, most economists of the time supported Hoover and his interventionist policies, there was a group of economists who criticized him, and whose arguments relied on the Austrian economics. For example, Haberler called Hoover's policy – “the public foretell”, and Professor from Columbia Parker Willis said that his policy “harmed already bad allocation of resources in US economy“.

But, regardless initial critics of Hoover's protectionist policies, Roosevelt continued its implementation through New Deal. The goal of Hoover-Roosevelt's program was to “prevent economic bubble from exhaling”, i.e. to bring economy in the deflation zone. Their programs were keeping “ill businesses” in life. Their measures were directing private capital and real savings, not into the market, but into non-economic public works and projects, which didn't contribute to the long-term adaptation of economy to market conditions. Did the New Deal really save US and world economy, as official history says? Or it just slowed down the recovery of US economy and prolonged it to 1948, as many researchers of crisis are claiming today?

¹² IBID: pp.15

This is what Robert Higgs wrote about in his book "Depression, War and Cold War"¹³. Higgs claimed that the New Deal with large number of laws, stronger regulations, and increased taxes created the discouraging environment, which dragged investors from investing. Such distrust of investors "kept economy in depression for 15 years".

3.4. Should We Get Back to Keynes or to Austrian Economics?

It seems that popularity of Keynesian economic theory, left in 1970's after the oil crisis, comes back!¹⁴ In order to keep economy "in growth and prosperity" the state should increase its spending, realize public works and other public projects and finance all these activities through budget deficits. In other words the economy (banks) needs more money in order to keep itself out of recession, or not to get into crisis. That is crucial economic philosophy in world today and the base of all recovery packages in US and West Europe. Even Joseph Stiglitz says in his text „Obama ersatz capitalism“ published by International Herald Tribune-u that Obama's policies are not win-win-win, but win-win-lose: banks gain, investors gain, tax payers lose!¹⁵ „We suffer from the crisis of trust. When high expenses of recovery packages become obvious to ordinary people, their distrust will deepen and solving the crisis will additionally complicate!“

What does Austrian economics say about the crisis and the causes of the crisis?

- (a) Interest rates can decrease for two reasons: (1) increased savings; (2) Central bank pushes interest rate down by its measures;
- (b) New projects are the answer of businesses to the reduced level of interest rates. Low level of interest rates encourages long-term investments – investments into capital goods.
- (c) If interest rates are pushed down by natural reason – increase in savings – then the market works with no interruption.
- (d) If interest rates are pushed down artificially – through Central bank manipulations – then these initiated projects cannot be finished;
- (e) Mises compares this situation with construction of the house, when the constructor thinks he has 20% of bricks more than he really has. He will construct the house completely different from the one he would build if he had the information on the exact number of bricks (if we assume he is not able to buy missing bricks). Dimensions of the house and its style will be

¹³ Higgs, Robert (2008) „Depresija, rat i strah (translation of *Depression, War and Cold War*)“, Politička kultura, Zagreb (prevod)

¹⁴ I recommend the book „Keynes For the Twenty-First Century“, edited by Mathew Forstater and Randal Wray, Palgrave Macmillan, 2008. I also find interesting the series of articles on crisis and its origins in International Herald Tribune, New York Times, Financial Times and The Economist!

¹⁵ See the series of articles on crisis in International Herald Tribune, New York Times, Financial Times and The Economist!

completely different. Farther he gets in construction, without realizing the mistake, the situation will get worse.

- (f) Economy acts similar to the house constructor. Following the policy of low interest rates, keeping interest rates below the market level, economic actors behave as if they have more money, then they really have. It gives incentives to invest money in wrong purposes, and those investments don't have foundation in real consumers' savings.
- (g) Housing boom is the classical example of this dynamic theory. Artificially low interest rates were giving the wrong investment incentives and huge amount of resources went into constructing houses. It's obvious this was unsustainable!
- (h) As soon as we abandon monetary manipulation, we will avoid wrong investment incentives, and thus wrong allocation of resources. House constructor is in better position if he stops the construction, then to continue it while living in illusion. The same is valid for an economy.

In a nutshell, the longer Central bank injects new money into economy, the longer and more painful the crisis will be.

3.5. Where Does the Money Come From?

„The state should make the money and give it to the banks in order to recover the economy and bring it back in normal condition!“ Does this sentence describe the essence of most statements made on the issue of crisis? Does it describe the basic idea of the measures that G-20 will undertake? Does anybody ask where that money is coming from?

But before that, what is money? Is it just an ordinary piece of paper, which can be printed whenever we want and as much as we want? Didn't we learn the consequences of such approach from our experience?

Money is always the represent of goods. Without desire to enter strict mathematical proofs of economic models, we can say that the quantity of money should be equal to the value of goods and services $R=N$! How much money we need, if there is no any goods or services ($R=0$)? The sum of money is also equal to 0 ($N=0$)! If the value of goods is 100, then the quantity of money is also 100! Of course, this is just a rough simplification introduced so as we should not analyze money isolated from goods and services (production)!

Will these “injections” of fresh money solve the crisis? Hardly, because the analysis in this paper proves that the crisis occurred as the result of money surplus and low interest rates. Injecting money into economic system will just postpone the solution

for the future. Some estimates say that the money quantity which circulates in world economy today is 3-4 times larger than the value of global gross product. The balloon had to pop, sooner or later.

Even George Stiglitz, who supports Keynes logics, said in his interview to German "Spiegel" in April 2009: "State is giving money to the banks as they can survive on the market, and banks are spending billions of dollars on bonuses and dividends. They rob tax payers and it must change!"

4. Instead of Conclusion

It is indisputable that the current crisis influenced change in behavior and change in understanding economics. The crisis encouraged catastrophic scenarios on the end of capitalism and voices that call for disappearance of free-market ideology. The solution is seen in increased regulation of banking industry and financial markets, i.e. in stimulating packages for recovery and nationalization of banks.

Is the transformation of banks into public service the way out of crisis? Czech President Vaclav Klaus strongly opposes this idea. Can bank industry function as the public service, partially owned by state, which guarantees and regulates this service? Imagine banks as a public service, similar to national state-owned TV stations! In this paper I was trying to emphasize the fact that if free-market logic is endangered in financial sector, it will necessarily lead to the distortion of other markets!

The problem, as I see it now, practically and intuitively bring me closer to the need to respect the vision of development of free-market and the institutions, which enable its functioning. The idea of free markets makes the base of contemporary civilization, and digital technology is one of its fundamentals. The world is the global stage – according to Japanese expert Kenichi Ohmae. The questions our civilization should answer today are not how to close ourselves, or how to give more power to national state, as Keynes was suggesting. The logic of so called "Keynes tub" is anachronism in contemporary world based on "the logic of the ocean". If we follow "Keynes tub" logic today, it is as we would "plow the sea"! Of course, it is easier to control the level and the temperature of water in a tub, then in the ocean! It is probably not possible to control the level and the temperature of the ocean! I am trying to point out the fact that if we don't understand and don't accept the necessity to implement "the logic of the ocean" – that is the crucial philosophical and practical problem world is facing today!

I see the deeper sources of the crisis in the clash between "the tub logic" (closed system with large role of state) and "the ocean logic" (open system and free-market)! The crisis pointed out **the clash between national and global**; the need to

understand the fact that the term “national” acquire new dimensions and thus become more distant from the economics, and closer to national culture, art and education! The crisis has shown that the world is economically inter-dependent and that inter-dependency will just grow. This growth of interdependence is caused by, among other things, **economic interests**, but also by the level and the features of **technology**.

I would use one Stiglitz association, despite the fact I agree with him only partially. Stiglitz said that “the fall of Berlin wall has shown that communist economy is not sustainable, and the bankruptcy of “Lehman Brothers” has shown that unrestrained capitalism is not sustainable. In my opinion, the crash of “Lehman Brothers” just proves that globalization brings the power of national bureaucracies to an end. That opens the process of breaking down the logic of welfare state, and developing the new **logic of united solidarity and philanthropy**! Does this crisis open the history of future, in which national states (bureaucracies) will disappear, and the world will become the community contained of hundreds small communities, which will be organized completely different from the organization of today’s bureaucracy? Can we consider the attempts to solve the crisis by money printing and injecting fresh money into economic systems as the attempts to keep the power of bureaucratic administration all around the world? If today’s civilization acted according to economic principle that the sum of values of all goods and services on global level is equal to the quantum of money in global terms, what would happen with “all those unproductive excrescences on the body of human community”?... But, free-market (capitalism) will not disappear from the parliament decisions or NGO requests, as well as global and national bureaucracy. That is global conflict of interests.

Did Samuel Huntington read Maltus (who said that “population is increasing in geometric progression, while the growth of resources (food) follow arithmetic progression”) when he wrote “The Clash of Civilization”?

The only solution to this civilization conflict, which is becoming visible, is tolerance and democracy of free-market. Edgar Moren says that this crisis brings many dangerous and confirms that the world is sliding into disaster: „The crisis brings dangerous, but it also brings the opportunities! The crisis increase uncertainty and rigidity of the institutions, but the waves of new forces occur, whether these forces are creative or destructive.“¹⁶

A question arises in my head: Is this the replication of 15th century, when Nicolo Machiavelli “broke down” the role of church and created the condition for the birth of national state? Is Bill Gates this new Machiavelli, which is “breaking down” the role of state and create conditions for birth of global community of world’s nations?

¹⁶ Magazin NIN, April 7th 2009

Can we think of "globalism and localism" as of the "humanism and renaissance" of modern age?

This seems too much philosophical question! However, Einstein said "Imagination is more important than the knowledge".

The crisis we are facing today reveal great lack of knowledge, but even more, it reveals the lack of imagination and vision!

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FROM SOCIAL DEMOCRACY TO LIBERAL SOCIALISM: A PROPERTY RIGHTS ANALYSIS OF THE TRANSITION IN EUROPE

Abstract: *Two important lessons of all socialist experiments to date are: socialism has repeatedly failed to duplicate the accomplishments of capitalism, and socialism refuses to die. At the turn of 21st century, a new type of socialism, liberal socialism, is growing in Europe. Analysis shows that a major reason for the rise of liberal socialism lies in its success in eroding the two key institutions of capitalism, private property rights and the freedom of exchange. Unlike communism, which used brute force to replace private property rights and free exchange with state ownership and central planning, liberal socialism is spreading the wealth around, creating entitlement programs, supporting labor unions and promoting "fair" trade. The common objective of those and similar policies is to lower the costs of the emergence of liberal socialism by replacing the capitalist culture of independence based on self-responsibility and self-determination in open and competitive markets with the culture of dependence on the state.*

Key words: *property rights, transition, capitalism, socialism, social democracy*

Resumee: *Zwei wichtige Lektionen über alle sozialistischen Experimente bis heute sind: Sozialismus ist es noch nie gelungen die wiederholung, der Errungenschaften des Kapitalismus und Sozialismus akzeptiert nicht denn eigenen Untergang. Zu Beginn des 21. Jahrhundert die neue art des Sozialismus - Entstehung des liberal Sozialismus in Europa. Die Analyse zeigt, dass der Hauptgrund für die Entstehung des liberalen Sozialismus in der Gefährdung beider grundlegenden Institutionen des Kapitalismus ist - Privateigentum und freier Handel. Im Gegensatz zum Kommunismus, die brutaler Gewalt nutzt, zum ersetzen von Privateigentum und den freien Austausch von Staatseigentum und zentrale Planung, der liberale Sozialismus ist gekennzeichnet von Programmen, die fördern die Vermehrung des Reichtums, die aufstellung neuer Rechte, die Unterstützung von Gewerkschaften und "Fairer" Handel. Das gemeinsame Ziel dieser und ähnlicher Politik ist es, die Reduzierung der Kosten der Einführung des liberalen Sozialismus durch die Reduzierung der kapitalistischen Kultur der Unabhängigkeit, basierend auf dem Prinzip der Eigenverantwortung und unabhängige Entscheidung auf einen offenen und Wettbewerbsmarkt, kulturell abhängig von dem Staat.*

Резюме: *Два важных вывода всех социалистических экспериментов до сих пор следующие: социализму так и не удалось повторить достижения капитализма и социализм просто не принимает свою смерть. В начале 21. Века в европе выступает новый тип социализма - либеральный социализм. Анали показывает, что основной причиной для развития либерального социализма является нарушение двух основных*

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институтов капитализма - частной собственности и свободы обмена. В отличие от коммунизма, который использует грубую силу, чтобы заменить частную собственность и свободный обмен государственным имуществом и центральным планированием, либеральный социализм характеризуется программой, которая способствует увеличению богатства, созданию новых прав, поддержки для профсоюзов и "справедливой" торговли. Общая цель этой и подобной им политики заключается в сокращении расходов установления либерального социализма чередованием капиталистической культуры независимости, основанной на принципе личной ответственности и самостоятельного принятия решений в открытом и конкурентном рынке, с культурой зависимости от государства.

INTRODUCTION

The problem with socialism is that you eventually run out of other people's money.
Margaret Thatcher

A defining feature of the 20th century was the struggle between capitalism and socialism. Three major applications of the socialist doctrine: Fascism, National-Socialism and Communism waged this fight against capitalism. Consistent with the socialist doctrine, as it developed in the eighteenth and nineteenth centuries, fascism, national-socialism and communism blamed the economic and social inequalities of capitalism on the behavioral consequences of private property rights and competitive markets.

All three types of socialism shared a major premise that their respective visions of a "just" society should replace the spontaneous order of capitalism. This premise provided fascists, national-socialists and communists with the political justification to replace the rule of law and individual liberties with the rule of men. Hence, all three types of socialism were equally unconstrained by law, customs and morality. The individual was a mere instrument for the achievement of the ends as defined by the ruling elite. Communism was openly hostile to the right of ownership, whereas fascism and national-socialism settled for controlling and directing the use of resources nominally owned by individual citizens. Like the competing families of underworld, fascism, national-socialism and communism went to war (hot and cold) with each other as well as with the rest of the world.

While all three types of socialism were equally oppressive, fascism and national-socialism played a relatively minor ideological role in the century long competition between socialism and capitalism. Communism, on the other hand, was a major player in the last century. By promising salvation on this side of haven, Marxism-Leninism gave socialism a pseudo religious content. This pseudo-religious content of Marxism-Leninism justified the dictatorship of the communist party as the self-appointed avant-garde of the self-proclaimed laws of history.

Two important lessons of all socialist experiments to date are: (1) socialism has repeatedly failed to duplicate the accomplishments of capitalism, and (2) socialism refuses to die. Every time one type of socialism failed, the critics of capitalism have been quick to come up with a new one. And there has been no shortage of the *White Knights* riding into the town to salvage socialism. Central economic planning in Stalin's Russia, self-management in Tito's Yugoslavia, the Red Guard in Mao's China, Che's crusade in South America, Ho's re-education in Vietnam and Castro's rape of Cuba had the same objective of making the economic performance of socialism superior to capitalism. And they have all failed to accomplish that objective.

At the turn of 21st century, socialism is on the march once again. Western Europe is in the process of transition from social democracy to socialism. Socialists and pro-collectivists parties in Central and Eastern Europe are recovering after the collapse of communism. What in the early 1990s was supposed to be the transition from socialism to capitalism is slowly turning into the transition from socialism to socialism. The European Union is helping the transition to socialism *via* numerous regulations supportive of 'fair trade', wealth redistribution, environmentalism, global warnings, multiculturalism and all other movements that require government controls of the allocation of resources. In the United States, the Obama Administration is using the economic crisis that began in 2008 as an excuse to initiate the process of 'spreading the wealth around'.

Given the lesson of history, there is no compelling reason to assume that this new type of socialism that is emerging on the European continent, I call it *liberal socialism*,¹ will not, like its predecessors, fail to duplicate the economic efficiency of capitalism. The purpose of this paper is to show why and how the emerging liberal socialism in Europe is more dangerous than its predecessors, even though, like its predecessors, liberal socialism is equally incapable of duplicating the accomplishments of capitalism.

However, a few remarks about the United States seem in order. President Obama is using the current economic crisis to open the gates for the import of liberal socialism into the United States. His three major programs, socialized medicine, federalized education and federal government energy policy will, if implemented, transfer decisions on winners and losers from competitive markets to Washington D.C. However, the importation of socialism and even social democracy into the United States is going to be more difficult enterprise for Obama than for his European counterparts because the United States has neither the tradition of social democracy,

¹ To the best of my knowledge the term liberal socialism was used only once before and in a very different context. See Chilosi, Alberto, 'Duhring's Socialitarian Model of Economic Communes and its Influence on the Development of Socialist Thought and Practice' (September 15, 1997, revised). Available at SSRN: <http://ssrn.com/abstract=55155>

a close relative of socialism, nor have American intellectuals ever shared the fascination of Western intellectuals with various socialist doctrines. Obama and his advisors have also repeatedly said that the current crisis has proved that “unrestrained” free markets do not work. Their remarks are misleading because they are not telling us which system has done better than Anglo-American capitalism; what is the system they want to replace the free-markets, private-economy with, and on what evidence?

The paper has four sections. The introductory section reviews a few elementary characteristics of private property rights, free exchange and economic efficiency that are relevant for analysis of the economic performance of liberal socialism. The second section discusses the meaning of liberal socialism, its causes and consequences, and the role of the European Union in supporting the institutions of liberal socialism. The last section of the paper focuses on the behavior of business firm in liberal socialism. Except for occasional references, the paper is about liberal socialism in Western and Eastern Europe. The United Kingdom, the United States and the rest of the world are left out of analysis.

ECONOMICS 101

It is not true that administration of an economy is simply technical problem devolving from the basic “given” conditions.

G. Warren Nutter

Free Exchange and Economic Efficiency

We live in a world of scarcity; that is, what we want exceeds what we have. The desire for more satisfaction is a predictable consequence of scarcity. Exchange is a means by which people seek more satisfaction for themselves. Individuals enter into exchange because they *expect* that their *benefits* from acquiring a good will exceed their *costs*².

The satisfaction a person receives from a good is purely subjective. There is no way for others to know the subjective satisfaction that one derives from acquiring that good. Thus, only voluntary exchange can move goods from lower- to higher-valued uses. To leave some exchange opportunities unexploited means that the allocation of resources is not efficient. By holding people to their promises, the law of contract increases the extent of exchange.

² The meaning of three underlined terms is as follows: The benefit from exchange is the increment in the subjective satisfaction a person derives from acquiring the right to use a good. The *cost* of exchange is the subjective satisfaction a person has to give up. When someone spends \$100 on a bottle of wine, the true cost of that wine is the satisfaction that would be available from another bundle of goods that \$100 could buy (i.e., opportunity cost). In a world of uncertainty and incomplete information, no one can predict the exact consequences of exchange

An important aspect of the spontaneous order that emerges from the voluntary interactions of individuals pursuing their own ends is that the value of resources in their alternative uses is identified by the only source of value: *the individual* as he acts on his subjective preferences. James Buchanan wrote: "Economic performance can only be conceived in values; but how are values determined? By prices, and prices emerge only in markets. They have no meaning in a non-market context ...where the choice-influenced opportunity costs are ignored." This quote captures the meaning of economic efficiency which is here defined as. The economic efficiency of the use of resources to produce goods and the allocation of goods among competing uses is expressed in the process through which voluntary interactions are carried out, leading into the unknown outcomes.³

At this point, two side-comments are appropriate. First, in a world of uncertainty and incomplete information we can never be sure that an outcome of human interactions is efficient. The best we can do is to determine whether the prevailing system of incentives and constraints encourage human interactions that are consistent with economic efficiency. For that reason, I prefer to use the term *efficiency-friendly*. Second, the paper's references to the so-called Anglo-American capitalism, which is the institutionalized classical liberalism impregnated with positive transaction costs and not-so-limited government.

Property Rights

From the dawn of human history, individuals have recognized the importance of property rights for their survival. Primitive men fought each other for the right of access to better caves; tribes claimed property rights in the area where fishing or hunting was good; and a struggle between two different concepts of property rights, as represented by capitalism and socialism, consumed the entire 20th century. Roman law and the common law of England developed a number of well-defined categories of property rights that are still with us, such as private property right, communal property rights and state (public) ownership. However, it was only in the 1960s that scholars began to translate the centuries of awareness of the importance of property rights into the economic theory of property rights.

³ To judge the economic efficiency by the attainment of a predetermined outcome or some quantitative measurements ignores our subjective preferences. And ignoring our subjective preferences leads to misleading conclusions about economic performance. A relevant example is the evaluation of the economic performance of the former Soviet Union by three neo-classical economists shortly before the country disintegrated. Robert Heilbroner and Lester Thurow wrote: "Can economic command significantly compress and accelerate the growth process? The remarkable performance of the Soviet Union suggests that it can. In 1920 Russia was but a minor figure in the economic councils of the world. Today it is a country whose economic achievements bear comparison with those of the United States" (1984, 629). Paul Samuelson said: "It is a vulgar mistake to think that most people in Eastern Europe are miserable... The gap between Western and Eastern living standard may narrow in the future" (1980, 624).

Property rights are the legal and customary relations among individuals that arise from the existence of scarce goods and pertain to their use. That is, property rights are the norms of behavior that individuals must observe in interaction with other individuals and groups or bear the costs of violation. By implication, different property rights have different economic consequences. An economic theory of property rights must then identify the effects of alternative property rights on transaction costs and incentives, analyze the effects of transaction costs and incentives on human behavior, and offer evidence for refutable implications of alternative property rights on the economy. With respect to business firms, the property rights approach has to explain the consequences of alternative property rights on the relationship between the supply efforts of value-creating resources and the appropriation of economic rents.

The exclusivity and transferability of ownership are two components of private property rights that set it apart from other types of property rights. The exclusivity of ownership means that the owner decides what to do with his goods, captures the benefits of his decision, and bears the costs. The marriage between bearing the costs of one's decision and capturing the benefits from that decision has two efficiency-friendly consequences. The owner has incentives to seek the highest-valued use for his goods, and the owner has strong incentives to take risk associated with the creation of new wealth (i.e., entrepreneurship).

The transferability of ownership also has two efficiency-friendly consequences. The owner can sell his property, say apartment building, for a lump sum, or the owner can choose to take the value of his asset as a flow of rents. An important consequence of this choice, which other types of property rights do not provide, is that individuals can adjust the composition of their wealth in accordance with their attitude toward risk.

LIBERAL SOCIALISM

My reading of history convinces me that most bad government results from too much government

Thomas Jefferson

Meaning of Liberal Socialism

Liberal socialism, like its predecessors, has two interdependent objectives that set it apart from capitalism: (1) the state should control the use of resource and (2) the collective choice should replace the rights of individuals to pursue their ends. Individual preferences need to be shifted in more "acceptable" directions. The French term, *dirigisme*, correctly describes this mind-set

Liberal socialism has also two characteristics that set it apart from its socialist predecessors. (1) Liberal socialism is emerging from within European social democracies via free and democratic elections. The transition from social democracy to liberal socialism is a process characterized by the erosion of private entrepreneurship and the middle class acceptance of mandated benefits. Analysis would gain little from attempts to identify the exact moment of transition from social democracy to liberal socialism, and even less from attempts to provide a narrow definition of liberal socialism. If, once upon a time, we insisted on establishing the exact time capitalism was born and its exact definition we would be still arguing those points and miss all the knowledge of the history and economic consequences of the system.

(2) Liberal socialism accepts private property rights. However, the attainment of pre-determined outcomes means that the state has to attenuate private property rights. The term attenuation of private property rights refers to restrictions of either the exclusivity of ownership (e.g., the owner of an apartment cannot simply tell his tenant to vacate the place), or the transferability of ownership (e.g., price controls) or the legal protection of private property rights (e.g., the enforcement of property rights in Venezuela or Putin's Russia). The attenuation of private property rights has three interdependent consequences. It weakens the owner's freedom to use his goods in accordance with his subjective preferences; it enables the state to replace competitive markets in choosing winners and losers in total disregard of individuals' subjective preferences; and it raises the transaction costs of allocating resources to their highest-valued uses.

The fact that European leaders seriously consider the concept of 'fair trade' is the best evidence that liberal socialism attenuates private property rights and rejects the spontaneous order that emerges from the voluntary interactions of individuals in open markets. Fair Trade is a neutral term that has non-neutral implications. It imposes non-market terms of exchange between developed and developing countries. The term is also used by labor unions in developed countries to demand restrictions on the import of goods produced by 'exploited' workers elsewhere. In essence, fair trade is a façade of words hiding attenuation of the transferability of private property rights.

The consequences of the attenuation of private property rights define the major difference between the social fabric of capitalism and liberal socialism. Liberal socialism sees the community as an organic whole that has a common good. The term common good or, to use modern jargon, social justice, is the facade of words hiding the redistribution of wealth organized and directed by people who do not own the resources that are being distributed. In contrast, the capitalist community is a voluntary association of individuals who enter and leave the community in the pursuit of their own ends. The function of capitalist institutions is to enhance individual interactions leading to the unknown outcome. If the rules encouraging

voluntary interactions were fair and good then any outcome that emerges from voluntary interactions is good and fair outcome.

Philosophical and Legal Origins of Liberal Socialism

In the seventeenth and eighteenth centuries, France became the birth place of socialist ideas. French socialists raised a question: What can be done to eliminate the social and economic inequalities of capitalism? The answer was syndicalism and revolution. In the 19th and early 20th century, French socialists saw syndicalism as the training school for the socialist revolution (Laidler, 378-9). The French Revolution of 1789 was not a socialist enterprise but it did favor weak property rights and a strong state. Moreover, the French Revolution was not carried out in the name of the individual. It was carried out in the name of centralism enforced by "enlightened" ruling elite. In that sense, the French Revolution made a contribution to the-then developing socialist doctrine.

At the time of their birth, most European social democratic parties were Marxists. For example, at the Erfurt Congress in 1891, the social democratic party of Germany accepted orthodox Marxism.⁴ In the 20th century social democratic parties began to move away from Marxism. It was as late as 1959 that the social democratic party of Germany explicitly rejected Marxism. The major reason was the realization that democratic processes could slowly bring about liberal socialism. The fact that the role of powerful state was never seriously questioned on the European continent, as it has been in the Anglo-American legal and cultural tradition, is helping the on-going transition from social democracy to liberal socialism.⁵

Liberal Socialism and Private Property Rights

Liberal socialism is suspicious of the freedom of choice not necessarily because of any lack of interest in individual liberties but because individual choices in the free market do not generate output and income distribution consistent with its concept of common good or social justice. As said earlier, to remedy this shortcoming, liberal

⁴ Yet, social democratic parties also had critics of orthodox Marxism. For example, Eduard Bernstein (1850-1932), the leader of the Bavarian Social Democrats, was a leading critic of the orthodox Marxism. Bernstein and his followers argued that Marx's criticism of capitalism was right in principle but that evidence called for adjustments in orthodox Marxism. They asserted that social conditions did not develop as the Communist Manifesto predicted; that the increase in wealth was not accompanied by a decrease in the number of wealthy capitalists; and that Marx's economic interpretation of history underestimated the effects of morals, culture and customs on economic performance (Laidler, 295-302).

⁵ Labor and business laws throughout Europe offer good evidence of the effects of the philosophical origins of liberal socialism. In Germany, the attenuation of property rights in business firms (i.e., state interference with the subjective preferences of property owners) has a long history. As early as in 1835, professors Robert Von Mohl, Wilhelm Roscher and Bruno Hildebrand proposed the creation of "workers' committees" in business firms because, they argued, capitalism had failed to emphasize moral issues. The trend of transferring property rights in business forms continued in Germany to date.

socialism attenuates private property rights. The attenuation of private property rights interferes with voluntary interactions among free individuals. Interference with voluntary interactions in open markets means the interference with the subjective preferences of interacting individuals. The interference with the subjective preferences of interacting individuals, in turn, interferes with the flow of goods and services from lower- to higher-valued uses. In the end, liberal socialism fails to duplicate the economic efficiency of capitalism. How?

The value of goods depends less on the flow of services from the goods that are being traded and much more on the bundle of property rights to do things with those goods. John takes better care of the car he owns than the one he leases, even though they offer the same flow of services. Jane takes better care of the apartment she owns than the one she rents. Public housing projects deteriorate faster than privately owned buildings. Private lakes are cleaner than public lakes. Labor unions attenuate the rights of workers to get jobs at wages they find acceptable. The owner of apartment building subject to price controls has fewer incentives to maintain his property than the owner of apartment building that is not subject to such restrictions (that is so because the rate of return on resources invested in maintaining buildings subject to price controls are less than the return from investing the same funds elsewhere). In all these cases, the values of goods that are traded are determined less by the flow of services from those goods and much more by the bundle of rights to do things with the goods that are being traded.

Measuring the Effects of the Attenuation of Private Property Rights

The Index of Economic Freedom published jointly by the Heritage Foundation and the Wall Street Journal, and the Economic Freedom of the World Index published by Fraser Institute have established that strong positive correlation exists between economic freedom and economic growth.⁶ To measure economic freedom, both indexes use categories that are consistent with the institutions and policies supportive of economic efficiency. To say that a country has become freer means that it has become more efficiency-friendly.

De Haan and Sturm (2000) tested the Fraser Index and found that improvements in economic freedom foster economic growth. Stocker (2005) got similar results. He found (p.589) that “increases in economic freedom are associated with higher equity returns, while the absolute level of beginning and ending economic freedom do not affect equity returns.” James Gwartney wrote (2003, p.3): “The maintenance over a lengthy period of time of institutions and policies consistent with economic freedom is a major determinant of cross-country differences in per capita GDP... cross-country differences in the mean rating during 1980-2000 explain 63.2 per cent of the cross-country variations in 2000 per capita GDP.” Bernhard Heitger (2004) found

⁶ Both indexes are about economic freedom only. Political and civil freedoms are not included in either of these two indexes.

that “estimating the direct relationship between property rights and end-of-period per capita incomes yields a highly significant regressor and indicates that a doubling in the index of property rights more than doubles living standards.” It is fair to say that both indexes have passed the test of time.

The paper uses the Index of Economic Freedom published by the Heritage Foundation and the Wall Street Journal (hereafter: *Index*).⁷ The Index uses ten categories to measure economic freedoms. Given the purpose of this paper, the most important categories affecting private property rights in liberal socialism are *Property Rights*, *Business Freedom* and *Labor Freedom*. Property rights category measures primarily the legal protection of private property, including the effectiveness and honesty of judicial system. Business Freedom is primarily about the transaction costs (red tape) of opening, operating and closing business firms. Labor Freedom is about the state interference with the rights of individuals to work for wages they find acceptable, the rights of businesses to hire and fire workers, wage controls, support for labor unions, and various safety regulations.

There is a critical difference between these three categories⁸. The first one (property rights) measures the protection of the bundle of property rights *without* specifying the contents of the bundle of rights that are being protected. The second and third category (business and labor freedoms) specify the bundle of rights that *need* to be protected.

The backbone of the Anglo-American common law tradition is that the primary function of private property rights is to serve the subjective preferences of property owners. Those preferences create incentives that maximize the extent of exchange (i.e., move resources to their highest valued uses). The political and legal tradition of Western Europe (not including the United Kingdom and Ireland, two common law countries) has constrained the function of private property rights from serving the subjective preferences of owners. In many West European countries the owner of an apartment cannot simply ask his tenant to vacate the place within a customary period. The German law protects private property rights as long as they serve ‘human dignity’ and welfare programs (Alexander 2003). The owner of a business in Spain is reluctant to hire workers because the costs of firing them are high. In France, the owner has to pay a tax (penalty) in order to close down his establishment. Italian legal system protects private property rights only insofar as they serve a social function as defined by the state (Mingardi 2005).

The tradition of the rule of law in Western Europe predicts high scores for the protection of property rights which the emerging liberal socialism wants to preserve,

⁷ The Index classifies all countries into five groups: *free* (80-100), *mostly free* (70-79.9), *moderately free* (60-69.9), *mostly unfree* (50-59.9), and *repressed* (0-49.9). The score of 1 is the worst and the score of 100 is the best.

⁸ The statement is challengeable because categories overlap and the paper uses only the most important part of the description of each category.

and lower scores for business and labor freedoms, which liberal socialism wants to attenuate. Indeed, the Index for Germany shows a high score for property rights category (90) and a low score for labor freedom category (43) even though both categories are about property rights. The former defines the protection of private property rights, while the latter defines the bundles of private property rights that are being protected. Also, the United States and Germany have the same score of 90 for property rights category. Yet, the bundle of rights that is being protected is not the same in those two countries.

In Central and Eastern Europe (hereafter: C&EE), the social forces affecting the attenuation of private property rights are different from those in Western Europe. Except for lingering memories of the rule of law in the parts of C&EE that belonged to the Austro-Hungarian Monarchy, the years of socialist rule has completely destroyed people's confidence in the legal system. The law is perceived as a mechanism the rulers use to do whatever the rulers want; the law is taken no more seriously than the promises of used car dealers

The prevailing culture in C&EE is not homogenous but it has a bias toward collectivism, egalitarianism, and shared values that pre-dates communism. The heterogeneity of culture in C&EE stems from the influence of three empires (Austro-Hungarian, Russian, and Ottoman) and three religions (Roman Catholic, Orthodox, and Islam). The culture of collectivism and egalitarianism gets stronger the farther east and southeast one travels. The following three quotes capture the essence of the socio-economic effects of three empires and three religions in C&EE.

Perry Anderson (1974, 429) explained the lingering memories of the rule of law from the days of Austro-Hungarian Monarchy as follows: "The age in which 'absolutist' public authority was imposed was also simultaneously the age in which 'absolute' private property was progressively consolidated. It was this momentous social difference which separated the Bourbon, Habsburg, or Tudor monarchies from any Sultanate, or [the Romanovs]." Antonina Zhelyazkova (2003, 140-141) described today's Albanian family. "Family community [is] composed of three or four generations, with a high level of internal solidarity. Within the [family] there is a strict, clear-cut age hierarchy, where the father's...word is law...this is due to the age-old internal ethno-cultural mechanism, which ...contributes to the preservation of their tradition." Writing about Russian culture, Silke Stahl (2001, 157) said: "In Russia [cultural] institutions found their expression in egalitarianism and collectivism...The reasons for egalitarianism, and collectivism [in Russia] can be found in religious beliefs."

To measure the effects of liberal socialism on the attenuation of private property rights, Table 1 includes information from *2009 Index of Economic Freedom* on property rights, business freedom and labor freedom.

Since the effects of liberal socialism on private property rights are qualitatively different in Western Europe and C&EE, Table 1 divides European continent into two groups: Sixteen West European countries and nineteen East European countries. The first group consists of all West European countries including Finland and Greece but not the United Kingdom and Ireland. The United Kingdom and Ireland have different (common law) legal systems from the rest of Western Europe. The informal institutions in those two countries also differ from the rest of Western Europe. The second group includes all countries that belonged to the Warsaw pact plus all countries that belonged to the former Yugoslavia. The only East European country left out from Table 1 is Bosnia and Herzegovina, which is not a functional state. C&EE countries are then divided into countries that were the subject of greater influence of Western culture and those that were the subject of lesser influence from the West. The first group includes nine countries. The Czech Republic, Croatia, Hungary, Slovakia and Slovenia used to be part of the Austro-Hungarian Monarchy, which was short on democracy but strong on the rule of law. The Catholic Church brought Western culture to Poland. Religious influence of protestant churches and the centuries of strong trade with Germany and Sweden, contributed to customs and traditions in the Baltic States. The second group includes Bulgaria, Albania, Romania, Macedonia, Montenegro, Serbia, Moldova, Russia, Ukraine and Belarus.

The benchmark against which to compare the effects of liberal socialism in Europe on private property rights includes Hong Kong, Singapore, Australia, New Zealand, United States and Canada. All those countries are common law countries. Moreover, the Index classifies all of them as free or the most capitalist countries (scores 80-100).

Table 1: Private Property Rights in Liberal Socialism

	Private Property	Business Freedom	Labor Freedom	Average Score
Benchmark	90.83	94.97	90.95	92.25 (free)
Western Europe	81.25	84.59	59.51	75.12 (mostly free)
C&EE	44.42	66.88	56.42	55.91 (mostly unfree)
Pro-Western C&EE	58.63	71.79	59.24	63.22 (moder. free)
Non-Western C&EE	32.00	62.57	54.66	49.74 (repressed)

Source: Calculated from *2009 Index of Economic Freedom*, Heritage Foundation and Wall Street Journal, Washington D.C. Grading Scale: 80-100 Free; 70-79.9 Mostly Free; 60-69.9 Moderately Free; 50-59.9 Mostly Unfree; 0-49.9 Repressed

Information about the effects of liberal socialism on property rights (last column in Table 1) confirms analysis in the paper. Six capitalist countries have stronger property rights than liberal socialist countries of Western Europe. Property rights in Western Europe are stronger than in C&EE. And predictably, property rights within C&EE gets weaker as one moves farther East and Southeast.

The Seditious Role of EU in Promoting Liberal Socialism

The European Union was born in Western Europe, while C&EE was home of one of the most oppressive rules in human history. It would be surprising if the expectations about the role of EU were the same throughout the region. Western Europe is a heterogeneous region as is C&EE. Marxism-Leninism changed the rules of the game in C&EE at will and the secret police enforced the rules with no regard for human rights and privacy. Predictably, some people in member countries from C&EE (especially Czech Republic and Slovakia) see the flow of regulations coming down from Brussels as a betrayal of the post-communist hope for a society of free and responsible individuals. It is also true that many east Europeans see EU regulations as replacing the old despotic dictatorship with a flow of benevolent rules that are helping to control corrupt domestic politicians.

The issue that affects all member countries is that EU has added one more layer of bureaucracy to those already existing in member countries. Like all bureaucracies, EU bureaucracy has strong incentives to grow. And issuing and enforcing regulations is the most efficient way for any bureaucracy to grow. Some regulations enacted by EU are pro-free market while others are not. However, the distribution of regulations between pro-free market and anti-free market is not as important for judging the direction of economic changes as is the power of Brussels bureaucracy to issue and enforce regulations. And it is this growing power of Brussels bureaucracy to regulate that cannot be trusted.

Professor Epstein (2004, 31) understood the problem and formulated his impressions of the direction of EU as follows: “[The proposed EU] Constitution allows for such dominance at the center that it will take a political miracle for that competition to play a powerful role in the affairs of the EU. By giving rights with one hand and taking them away with the other, this proposed EU Constitution lacks any clear definition and structure... But when the dust settles, there will be more government and less freedom for all... My recommendation is therefore this: Opt for the economic free trade zone and consign the EU Constitution to the dust heap.”

The evidence suggests that Epstein got it right. Appendix on the protection of pigs and tomatoes is just a top of the iceberg which contains a huge and growing number of similar regulations that are amusing, costly and inefficient. What makes EU

regulations costly and inefficient is that they are less concerned with the protection of private property rights and a society of free and responsible individuals and much more with fair trade, environment, global warming, the right of all species (other than humans), and the scientific-political elite conviction that they know what people would demand if they knew what was good for them.

Vaclav Klaus has frequently spoken and written on the way Brussels has highjacked the great idea of creating the United Europe based on free trade and individual liberties. Recently, he said: "The undergoing weakening of democracy and of free markets on the European continent, connected with the European unification process, is a threatening phenomenon...[which] was the main building block of the European Constitution and it remains without substantial change in its new version, in the Lisbon Treaty." Klaus is right. When the proposed Constitution was voted down, Brussels invented the Lisbon Treaty. Now that the Lisbon treaty is not working out, there is talk of doing something else in order to get things rights. We observe that every time a country votes down one of EU preferred rules or propositions, Brussels tries to engineer another election, and then another until the rule wins a majority vote. Once that happens, another election is never suggested.

Professor O'Hear (2008, 231) wrote that one important consequence of Brussels' hunger for power is that "the enterprise to which EU is committed is first and foremost the creation of itself as a supra-governmental authority, a task of Hegelian pretension and of Sovietic proportion." Professor Norma Berry (2004, 33) argued that EU leaders have no intention of enacting a body of laws that would take away their discretionary powers: "As long ago as 1964, the Costa vs. ENEL decision from the European Court of Justice (ECJ) struck down an Italian statute that happened to conflict with an EU regulation on the ground that European law was superior to domestic legislation. It was the beginning of the activism of the ECJ." Vaclav Klaus has been even more specific about the effects of "harmonization". The essence of his position is that Brussels has been attenuating private property rights, constraining free-market competition, eroding the sovereignty of member states, and transferring decision making from member states to Brussels.

Many years ago, Professor Nutter (1969, 39) provided a succinct and powerful description of the policies pursued by the Soviet leadership. Nutter wrote:

It was Lenin's genius to recognize the importance of embellishing the Soviet system with all the trappings of democracy. If the people want a constitution, give them one, and even include the bill of rights. If they want a parliament, give them that, too. And a system of courts. If they want a federal system, create that myth as well. Above all, let them have elections, for the act of voting is what the common man most clearly associates with democracy.

Give them all these, but make sure that they have no effect on how things are run

It is arguable that the same description fits EU leadership. That is so because the story of EU is the story of unstoppable drive to replace local laws with European-wide rules leading to the centralization of power in Brussels. Appendixes at the end of this paper are evidence of this drive. And in the process of centralizing the power in Brussels, the EU supports the emergence of liberal socialism in Europe

THE BUSINESS FIRM IN LIBERAL SOCIALISM

Some regard private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful see it for what it really is - the strong horse that pulls the whole cart.

Winston Churchill

The economic performance of any system depends on the performance of business enterprises. And the performance of business firms depends on the prevailing property rights in resources used by business firms. The focus of this section is on the incentive effects of the attenuation of property rights in liberal socialism. For comparison, analysis begins with the incentive effects of private property rights in capitalism.

The Behavior of Capitalist Firm

The ownership of the firm is about rights (Alchian and Demsetz, 1972). To say that a firm is privately owned means that the owner has a well-defined bundle of rights in that firm. Three important rights that set the privately owned firm apart from other types of business firms are:

(1) *The owner's right to the revenue of the firm.* The owner has to pay contractual obligations of the firm. Any residual left after all other obligations of the firm are met from its revenue belongs to the owner. (2) *The owner's right to hire and fire members of the team.* The owner must have the right to hire and fire members of the team. Otherwise, the owner's incentives to monitor members of the team would be unenforceable. If in hiring new members of the team the owner had to satisfy criteria not related to the past performance and expected productivity of potential candidates, the team would be smaller, the costs of production would be higher, and marginal firms would not survive. An owner who had to incur high costs in order to justify firing a member of the team would have no credible threat to enforce incentives to supervise and monitor the performance of team members. (3) *The owner's right to sell the preceding two rights.* The right to transfer one's rights to

others at a mutually agreed upon price is a basic component of the right of ownership. The market price of a firm is the value of the owner's bundle of rights, which is the present value of the expected residual over the firm's life discounted at a going rate of interest.

The most important consequence of the bundle of rights that define privately owned firm is that *the owner bears changes in the value of the firm*. It means that the owner has incentives to seek ever larger profits. And the search for ever larger profits provides incentives for the owner to seek both the highest-valued uses for resources controlled by the firm as well as entrepreneurial profits. The former is about the efficient use of resources. The second is about economic development.

The incentives to seek ever larger profits mean that the owner of business firm has to satisfy consumers' preferences. To satisfy consumers' preferences, the owner has to incur the transaction costs of allocating resources controlled by the firm to their highest-valued uses. In addition to seeking the best use for resources controlled by the firm, the owner has to be alert to changes in consumers' preferences.

The bundle of property rights that define privately owned firm also provide the owner with strong incentives to seek entrepreneurial profits; that is, profits over and above normal rate of returns. Innovation, a major activity for seeking entrepreneurial profits, means doing something that was not done before. Doing something that was not done before increases the community's set of choices. By implication, voluntary acceptance of an innovation means that the community is better off. Thus, innovation is the engine of economic development. Being a novelty, it is impossible to know the risk of innovation. A powerful incentive to accept the uncertainty about the outcome is the innovator's property right in the *entire* entrepreneurial (temporary monopoly) profit of a successful innovation. Any attenuation of the innovators property rights in the entire profit reduces the incentives to innovate and slows down economic development.

Finally, academic research and empirical evidence have shown that better understanding of the efficiency implications of antitrust laws by judges (Kovacic and Shapiro, 2000), the protection of owners-investors by parliaments (La Porta et.al. 1999), the efficient market for management control (Manne, 1965) and decline in the power of labor unions increases the bundle of rights in privately owned firms and, in doing so, improves the performance of capitalist firms.

The Behavior of Liberal Socialist Firm

Unlike socialist movements of the past, liberal socialism accepts private property rights. The acceptance of private property rights takes the form of various ways of attenuating them. The purpose of the attenuation of private property rights is to use privately owned resources to serve the objectives of socialist leaders.

The concept of industrial democracy is an umbrella for all the different method of attenuating private property rights in business firms. The focus of this section is on the efficiency consequences of labor participation in the management of business firms.

The concept of labor participation in the management of business firms has been thriving in Western Europe and EU long before the fall of socialism in Central and Eastern Europe. The former president of France, Giscard d'Estaing, said "Participation of workers' representatives in the life of their company reflects the workers' aspirations not be left out of decisions that concern them." Former chancellor of Germany, Willy Brandt, a devout socialist, said; "We consider the development of [labor participation in the management of business firms] to be one of our main tasks...in this, we start from the principle of equal rights and even balance of weight of employees and employers. Most importantly, the European Commission proclaimed labor participation in the management of business firms as one if its fundamental objectives. It said: "No less than one third of the members of the supervisory organ (i.e., board of directors) shall be appointed by the workers or their representatives."

In post-communist C&EE countries the tendency is to give managers and employees a large number of shares in their respective enterprises ether free of charges or at a significant discount (Mitra, Selowsky, et al. 2000, 75). This method of 'privatization' changes the balance of power between shareholders, managers and employees at the expense of shareholders. Freed from the pressure to maximize the residual, the alliance between labor and management tends to employ unneeded workers, make business decisions that maximize near-term cash flows, and offer pecuniary and non-pecuniary benefits to local bureaucrats in exchange for favorable treatments (Milovanovich (2007).

Two consequences of labor participation are inefficiencies in the allocation of resources within labor participatory firms and inefficiencies in the allocation of resources in the economy. Let us start with inefficiencies within the firm. Labor participation in the management of business firms means that employees have incentives to seek investment alternatives that shift incomes forward and postpone costs. The former benefits current employees, while the latter shifts current production costs to future generations of workers. For example, consider two investment alternatives of equal cost. The expected present value of one alternative is \$1,000 while the other yields only \$750 at a going rate of interest. However, if the returns from the first alternative are expected over a period of 20 years and those of the second over only 5 years, workers have incentives to push management in the direction of choosing the less efficient one. And they are likely to win because the attenuation of private property rights in liberal socialism shifts the balance of power away from shareholders to the coalition of managers and workers.

Let us now assume an open economy that has a mix of labor participatory forms and non-participatory enterprises. Attenuations in the owner's right to capture the residual (via sharing with workers) and the owner's right to hire and employees raise the costs of capital for labor participatory firms. . Given differences in the costs of capital, the rates of return in the labor participatory sector would fall relative to the rates of return in the labor non-participatory sector. The flow of capital from the labor participatory sector into the non-participatory sector would increase the returns on investment in the labor participatory sector relative to the returns on investment in the labor non-participatory sector. The flight of capital into the non-participatory sector would continue until the equality in the rates of return is re-established. In the end, the labor participatory sector with attenuated private property rights would be smaller, produce smaller output, and charge higher prices relative to the non-participatory sector with private property rights.

The labor participation in the management of business forms is not efficiency-friendly method of organizing production. Not surprisingly, labor participatory firms do not appear voluntarily in any significant numbers.⁹ To avoid the embarrassment, social democrats and socialists have incentives to mandate labor participation in the management of business firms and then to protect labor participatory firms from competition by other types of enterprises.

We can say that the attenuated private property rights in liberal socialism transfer the guidance of production from the competitive process in which the knowledge of all is used to generate efficiency-friendly outcomes to specific individuals with limited knowledge, such as regulators, politicians and bureaucrats.

The Rate of Investment in Capitalism and Liberal Socialism

Liberal socialism preserves private business firms. It, however, attenuated the bundle of right that defines privately owned firms. And the attenuation of that bundle of rights has consequences discussed in the preceding section. One such consequence is the increase in the cost of capital. A growing body of literature shows that business firms in countries with Anglo-American capitalism earn returns on investment that is at least as large as their costs of capital, while enterprises on the continent of Europe earn on average returns on investment below their costs of capital.¹⁰ Of course, those returns have no relationship to the returns shareholders earn on their investments. Adjustments in share prices eventually bring the expected returns to shareholders on their investments into equality.

⁹ There is no law in the United States that says that there shall be no labor participation in the management of business forms. Yet, we observe an insignificant number of labor participatory firms

¹⁰ Gugler, K, Mueller, D., Yurtoglu, B. (2004), "Corporate Governance and Globalization," *Oxford Review of Economic Policy*, 20, No 1, 129-156. The evidence is about the rates of return in common law and civil law countries. However, those differences in legal systems coincide with the difference in Anglo-American and Continental capitalism. Moreover, they are also consistent with the ranking of countries in the Index of Economic Freedom.

The issue is the efficiency effects of the higher costs of capital in liberal socialism on the rate of investment of business firms and the redistribution of wealth. In the 1960s, Professor Witte (1963) developed a model on the determinants of the rate of investment of business firms. Key proposition of Witte's model was that "the firm's demand is for stock rather than for flow of capital goods because the services it wishes to have available are at least functionally related to the stock and not to the rate of change of the stock;" and "I find that a sufficient condition for the existence of a market-equilibrium relationship between the aggregative rate of investment and the rate of interest is a capacity and cost constraint on the rate of output of capital goods."¹¹

Witte's model was limited to analysis of the determinants of investment by business firms in the private-property, free-market economy. In the early 1970, I expanded Witte's model to show the effects of three additional types of property rights on the rate of investment by business firms (1971). The rest of this section relies on my 1971 research to highlight the efficiency effects of the attenuation of private property rights in liberal socialism on the redistribution of wealth and rate of investment by business firms.

As a footnote, it is true that macroeconomics has made large advances since Witte wrote his article. Yet, Witte's model is, I believe, still conceptually relevant because of his emphasis on the microeconomic foundations of the aggregate demand for investment. Moreover, most of advances in macroeconomics have been technical improvements at the expense of the incentive effects of alternative institutions. And in 1990s, Central and Eastern European countries were in the initial stages of institutional restructuring; that is, they were moving away from their prevailing institutional arrangements. Yet, a major advice they kept getting was to maintain macrostability. Macrostability presumes policies based on and directed at the prevailing institutions. It means that whatever macroeconomists wanted to stabilize had to raise the transaction costs of the spontaneous development of new institutions. Stabilization programs were then based on technically impeccable models based on assumptions that new equilibriums are created instantaneously or that government fine-tuning of economic process is possible or both. For those assumptions to be borne out, Central and Eastern Europe needed the Second Coming.

The basic line of Witte's analysis of the aggregate rate of investment in capitalism is as follows: The SS curve in Figure 1 is the assumed supply of the existing stock of capital in the community. The demand curve (D_1D_1) is the demand for the capital stock to hold at the rate of interest (r_1). This price of capital is determined in the capital market where the rate of interest is equated to the percentage return from the capital stock.

¹¹ Witte, J. (1963), "The Microfoundations of the Social Investment Function," *Journal of Political Economy*, 75, No5, pp. 441 and 456.

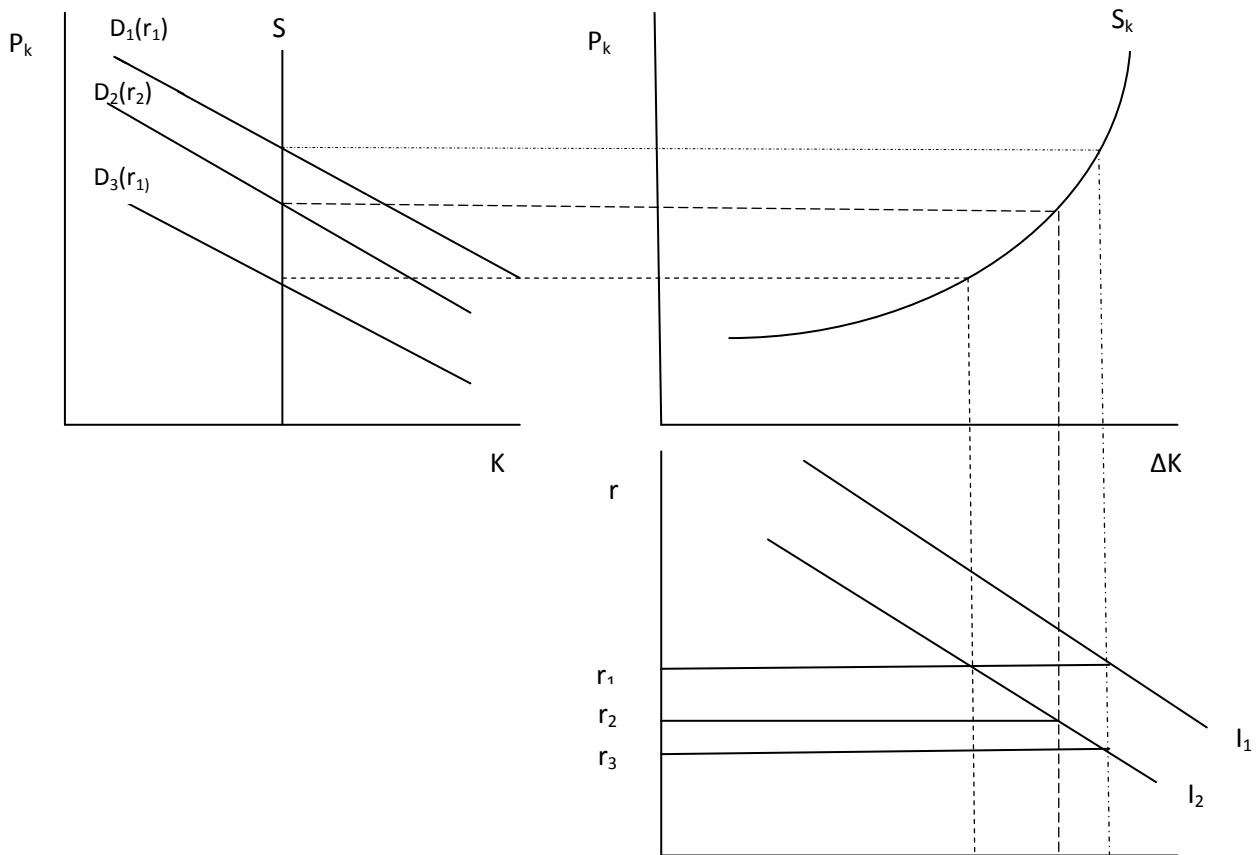
Let us now adjust Witte's analysis to the effects of attenuated private property rights on the aggregate investment in liberal socialism. As discussed earlier, the attenuation of private property rights has many forms. One form of attenuation of private property rights is restrictions on profits earned by business forms. Public utilities in the United States have operated for decades under such restrictions, profit restrictions (formal and/or informal) exist in European countries practicing industrial democracy, and windfall profit tax is still remembered in the United States.

It is clear that the managers have incentives to ignore profit controls and maximize profits as long as they could spend (OC) amount on the supply of nonpecuniary goods. Those incentives are constrained by the reaction of shareholders and state regulators. Shareholders have no reason to object to the managers' behavior which in a non-regulated firm would reduce their wealth. The managers hide their consumption of nonpecuniary goods from the state by reporting those expenditures as the costs of doing business.

It is obvious that the control of profit means the redistribution of income from shareholders to managers. What is much less obvious is that this redistribution of income reduces the community's wealth. Reporting the expenditures on the nonpecuniary goods as the costs of doing business limits the kind of goods the managers' can purchase for themselves and get away with. It means non-reported profits (OC) in Figure 2 are not allocated to their highest-valued uses.

For example, if the managers spent \$1,000,000 on nonpecuniary consumption (i.e., liberal use of the company plane, membership in golf clubs, expense accounts, etc.) that consumption would make them better off but not as well off as the most preferred bundle of goods worth \$1,000,000 would. At the same time, shareholders loss is \$1,000,000 in cash, which in the absence of profit controls they would be free to put to the highest-valued use. The result is a loss wealth. And lower wealth has implications on the rate of investment by business firms.

Figure 3



The control of profit results in a decrease in net earnings of the firm (DM in Figure 2). Given the rate of interest (r_1) the demand curve for capital stock shifts downward to (D_3D_3) in Figure 3, and the market price of capital goods falls. A corresponding increase in the demand for monetary and human assets would, via switching activities in different markets, reduce the market rate of interest to (r_2) and shift the demand curve for capital stock upward to say (D_2D_2), where (r_1) > (r_2). The investment function shifts from (I_1I_1) to (I_2I_2) is due to a loss of wealth. Given the consumers' time preference, savings are less at each rate of interest. An increase in demand for monetary and human assets would then not be strong enough to shift (D_2D_2) schedule back to (D_1D_1) and reduce the rate of interest r_1 to r_3 . Thus, the market rate of interest will be found somewhere between (r_1) and (r_3), say at (r_2). The

effect of the attenuation of private property rights via profit controls is loss of wealth, less investment and lower rate on interest.

CONCLUSIONS

The sacrifice of cognition is particularly easy to detect in objections to the market system introduced by discrepancies between one's desires, glorified as social values, and the results of market processes. However, our ability to visualize 'better' states more closely reflecting our preferences yields no evidence that this state can be realized.

Karl Brunner

All three major socialist movements from the last century, Communism, National-Socialism and Fascism, were either imposed by force (e.g., USSR, Spain) or were the outcome of one-man, one-vote, one-time type of election (e.g., Germany). Once in power, all three types of socialism relied on secret police to stay in power. Unlike its predecessors, liberal socialism is neither been imposed from without nor maintained by force. Liberal socialism has been emerging from within capitalism.

Analysis in this paper shows that a major reason for the rise of liberal socialism lies in its success in eroding the two key institutions of capitalism, private property rights and the freedom of exchange. Unlike communism, which used brute force to replace private property rights and free exchange with state ownership and economic planning, liberal socialism is 'bribing' people to voluntarily accept the erosion in those two key capitalist institutions and relies on free elections to validate the resulting institutional changes. The term bribing refers to government policies that are spreading the wealth around, creating entitlement programs, supporting labor unions, promoting fair trade, and enacting various legal restrictions on hiring and firing employees in privately owned firms. The common objective of those and similar policies is to lower the costs of the emergence of liberal socialism by replacing the capitalist culture of independence based on self-responsibility and self-determination in open and competitive markets with the culture of dependence on the state. I conjecture that the emergence and survival of liberal socialism depends, as Professor James Buchanan argued, on whether those policies succeed in making individuals 'afraid to be free'.¹²

Liberal socialism is the clear and present danger to free trade, competitive markets and individual liberties. It is unfortunate but also undeniable that Brussels bureaucracy is promoting policies that support cultural changes that liberal socialism needs for its survival. Speaking before the European parliament on February 19, 2009, Vaclav Klaus talked about the role of EU in enhancing the threat to the

¹² Buchanan, J. (2005), "Afraid to Be Free," Public Choice, 24, No 2, 19-31.

private-property, free-market economy and individual liberties. A few excerpts of Klaus' speech are the most effective summary of the message of this paper.

“We must say openly that the present economic system of the EU is a system of a suppressed market, a system of a permanently strengthening centrally controlled economy. Although history has more than clearly proven that this is a dead end, we find ourselves walking the same path once again. This results in a constant rise in both the extent of government masterminding and constraining of spontaneity of the market processes. In recent months, this trend has been further reinforced by incorrect interpretation of the causes of the present economic and financial crisis, as if it was caused by free market, while in reality it is just the contrary – caused by political manipulation

Many of you certainly know the name of the French economist Frederic Bastiat and his famous ‘Petition of the Candlemakers’, which has become a well-known and canonical reading, illustrating the absurdity of political interventions in the economy. On 14 November 2008 the European Commission approved a real, not a fictitious Bastiat’s Petition of the Candlemakers, and imposed a 66% tariff on candles imported from China. I would have never believed that a 160-year-old essay could become a reality, but it has happened. An inevitable effect of the extensive implementation of such measures in Europe is economic slowdown, if not a complete halt of economic growth. The only solution is liberalization and deregulation of the European economy.”

APPENDIX

Brussels Bureaucracy at Work

The three examples of EU directives on pigs and tomatoes are much more than an amusing message about its bureaucracy’s hunger for power. They tell the story of the kind of society that has been, for some time, replacing the free-market, private-property economy in Europe and is a serious threat to the future of liberty in the United States. .

Example One:

Protection of pigs

The European Union has laid down minimum standards for the welfare of pigs kept for rearing and fattening in order to protect the pigs and prevent distortion of competition between producers in different Member States.

ACT

Council Directive 91/630/EEC of 19 November 1991 laying down minimum standards for the protection of pigs [See amending acts]

SUMMARY

Established on the basis of the European Convention for the Protection of Animals Kept for Farming Purposes, Directive 98/58/EC lays down the Community provisions on animal welfare. It stipulates that all animals must be provided with housing, feed and care appropriate to their needs.

This Directive provides for minimum standards for the protection of pigs confined for rearing and fattening.

All holdings newly-built or rebuilt and/or brought into use for the first time after 1 January 2003 must comply with the following requirements:

- each weaner or rearing pig reared in a group must be provided with a minimum statutory unobstructed floor area, depending on its weight;
- each sow and gilt (a female pig that has not yet farrowed) must be provided with a minimum statutory unobstructed floor area of 2.25 m² and 1.64 m² respectively;
- flooring surfaces must meet standards concerning the minimum slat width and the maximum width of openings;
- the construction or conversion of installations in which sows and gilts are tethered is prohibited. The use of tethers for these animals is prohibited from 1 January 2006;
- sows and gilts shall be kept in groups during a period starting from 4 weeks after the service to 1 week before the expected time of farrowing. This provision does not apply to holdings with fewer than ten sows;
- sows and gilts kept in groups must be fed using a system which ensures that each individual can obtain sufficient food even when competitors for the food are present;
- to satisfy their hunger and given their need to chew, all dry pregnant sows and gilts must be given a sufficient quantity of bulky or high-fibre food as well as high-energy food;
- pigs kept in groups that are aggressive, have been attacked by other pigs or are sick or injured may temporarily be kept in individual pens whose size would be sufficient for the animal to roam around easily, provided this does not contravene specific veterinary advice.

These provisions are obligatory for all holdings from 1 January 2013. However, they do not apply to holdings with fewer than six pigs or five sows with their piglets.

The Directive lays down minimum welfare standards concerning:

- the materials used in the construction of housing;
- the layout of housing: each pig must be able to lie down, rest and stand up without difficulty and see other pigs;
- the insulation, heating and ventilation of buildings and the light and noise levels within them;
- inspection of the pigs, which must be carried out at least daily: any sick or injured pigs must be treated without delay and, where necessary, examined by a veterinarian.
- measures to prevent aggression between animals;
- the cleaning and disinfection of the housing, utensils and equipment used;
- the daily provision of healthy feed suited to the age and weight of the pigs.

Specific provisions on the different categories of pig: boars, sows and gilts, piglets, weaners and rearing pigs.

Preferably before 1 January 2005, the Commission must submit to the Council a report on the socio-economic, sanitary and environmental conditions affecting intensive pig-farming systems accompanied, where appropriate, by proposals for improvements. The Council must then act by qualified majority no later than three months after receiving the report.

By 1 January 2008, the Commission must present a report to the Council on pig welfare, covering the effects of stocking density in different farming systems, the impact of stall and flooring design and the risks associated with tail biting. The report must also cover further developments of group-housing systems for pregnant sows, the determination of the space required by each animal and an examination of consumers' behaviour towards pigmeat.

The Commission and the Member States conduct on-the-spot checks to ensure that the Directive is being applied. Experts from the Commission may make on-the-spot checks in cooperation with the competent authorities, which must then take any measures revealed to be necessary by the checks.

In order to be imported into the Community, animals from third countries must be accompanied by a certificate stating that they have received treatment similar to that provided for in the Directive.¹¹ Member States have until 1 January 1994 to bring into force the laws, regulations and administrative provisions, including any

penalties, necessary to comply with the Directive. They may maintain or apply more stringent provisions.

Example Two:

LONDON, England -- A report that claimed British pigs would have to be supplied with toys to keep them content has been described as "utter eurosceptic rubbish" by European Union officials.

It had been reported that UK pig farmers would have to supply toys to pigs or face fines up to £2,500 under an EU directive.

But EU and UK officials knocked down the report, saying that under EU legislation on pig welfare, the animals only need to be given such rooting materials as straw, hay, wood, sawdust, compost or peat.

Jim Dougal, head of the European Commission in the UK, said: "There is no mention of toys in the EU directive. Yet again we see sections of the press resorting to invention in order to propagate their eurosceptic agenda.

"If the UK wants to tell farmers that they should supply toys for their pigs, that is matter for them."

UK Animal Welfare Minister Elliot Morley said: "Like many Euro myths, to suggest farmers are being ordered to give pigs toys is not true.

"Although it sounds amusing, there is a serious point to animal welfare behind the new pig directive which requires animals to have access to manipulable materials.

"This and other forms of environmental enrichment are examples of good management and it is already included in industry-run quality assurance schemes which farmers have applied for many years."

The EU legislation was introduced following scientific evidence that showed boredom in pigs could lead them to harm themselves and each other.

A spokesman for the UK Department of the Environment, Food and Rural Affairs (DEFRA) had been quoted as saying the regulations required all pigs to have access to a "sufficient quantity of manipulable materials."

"While straw and hay would do, obviously the use of a football or a chain would also do," the spokesman said.

"For many years now vets have been suggesting that you put a football or something to kick around into the stall with a horse if it is restless," he said.

"Basically, the same is true for pigs. If you put in a football or you dangle a chain they could nose it around and play with it, it is helpful."

Joyce D'Silva, chief executive of Compassion in World Farming, was critical of the way DEFRA handled the announcement of the new regulation.

"The EU directive on providing pigs with 'manipulable material' is a welfare measure designed to ensure they can carry out their natural rooting behaviour -- instead of living on barren, concrete slatted floors.

"The intention is to provide pigs with materials like straw or mushroom compost to allow them to root -- not basketballs as quoted by DEFRA.

"It is quite clear that there are people in DEFRA with little knowledge of pigs, apart from perhaps those they see in Hamleys toy shop.

"With this announcement, DEFRA are completely trivialising animal welfare issues."

It is true that farmers who fail to follow the new regulations could be fined up to £2,500 but would not face a jail sentence.

Example Three:

Proposed draft Codex standard for tomatoes (CX FFV 00/16)

The European Community wishes that the proposed draft concerned be amended on numerous points, in order to be harmonised with the existing international standards for this product: standard recommended by the UN/ECE Working Party on standardisation of perishable goods, OECD standard. These standards have existed for several decades and it is important that a possible new Codex standard for the same product is similar to them, if not identical, in order to avoid any confusion on the markets and to minimise overlapping between the work of the Codex Committee for fresh fruit and vegetables and the work of other international organisations. In these comments, account was taken of the draft revised standard for tomatoes, as approved by the last session of the UN/ECE specialised section of the standardisation of fresh fruit and vegetables, which proceeded in May 2000.

Paragraph 1: Definition of produce:

It is desirable to define, at this stage of the Codex standard, the principal commercial types of tomatoes on the market, because, according to the types, the provisions of the standard will vary. The European Community proposes distinguishing four commercial types of tomatoes: round tomatoes, ribbed tomatoes, oblong tomatoes and cherry tomatoes. The following paragraph could be added following the first subparagraph of part 1:

"Tomatoes may be classified into four commercial types:

- "round" or spherical type,
- "ribbed",
- "oblong" or "elongated",
- "cherry" tomatoes (including "cocktail" tomatoes). "

Paragraph 2.1 : Minimum requirements :

- At item 2.1, the third indent mentions that tomatoes must be of characteristic appearance and development of the variety. The European Community considers that these criteria must be according to the class in which tomatoes will be classified. For example, development defects such as light bumps have to be acceptable in class I. The Community proposes therefore suppressing this indent and tackling the question of the defects of appearance and of development in paragraph 2.2 (Classification), rather than in this paragraph which should concern minimum characteristics only.

- The fifth indent stipulates that tomatoes must be free of damage caused by exposure to the sun. The Community considers that certain defects due to exposure to the sun (light sunburns of the skin for example) are acceptable in the classes I and II. It does not wish therefore this indent to be included to the minimum characteristics. When this type of defect reaches an unacceptable level, even in class II, tomatoes have reached "deterioration such as to make it unfit for consumption": the fourth indent applies therefore. Accordingly, the European Community proposes suppressing the fifth indent of paragraph 2.1.

- The sixth indent mentions that tomatoes must be free of damage caused by frost or freezing. The European Community considers that these defects are also covered by the fourth indent (see OECD interpretative booklet, page 21). The Community proposes therefore suppressing this indent.

- The ninth indent mentions that tomatoes must be "practically free of pests and disease". The European Community believes "diseases" are included in "pests". Accordingly, the European Community proposes replacing the ninth and the tenth indents by the two following indents:

"practically free from pests,

- practically free damage caused by pests, "

- Increasingly tomatoes are presented in trusses, i.e. in whole inflorescence or part of inflorescence. In this case, it is necessary to envisage minimum requirements for the quality of stalks, in addition to the requirements, which apply to tomatoes. The

European Community proposes adding the following subparagraph at the end of paragraph 2.1:

"In the case of trusses of tomatoes, the stalks must be fresh, healthy, clean and free from all leaves and any visible foreign matter."

Paragraph 2.2. : Classification :

- Paragraph 2.2.1 stipulates that the shape of tomatoes must be typical of the variety. The European Community is in agreement with this requirement, but in the Extra Class, it wishes tomatoes to be characteristic of the variety in all points (shape, aspect, development). That makes it possible to suppress the indent dealing with the shape, because a tomato characteristic of the variety is inevitably "properly shaped". With regard to the uniformity of size and colouring, mentioned in the second subparagraph of paragraph 2.2.1, the European Community considers that this consideration has its place rather in paragraph 5.1 (Uniformity). The proposed draft Codex standard stipulates moreover that tomatoes shall be uniform in size in all Classes, and uniform in colouring in Extra Class. It is not therefore necessary to mention the requirement of uniformity of size and colouring in this paragraph.

On the other hand, it is necessary to specify, with regard to colouring, that tomatoes can be not characteristic of the variety. When tomatoes reached the degree of development and maturity mentioned as in point 2.1.1, they can, according to the envisaged duration of transport and its nature (chilled or not), present a range of colouring going from the green to the red. What is important is not therefore that colouring is typical of the variety, but that colouring is such that tomatoes will arrive at destination in a satisfactory condition. The Community proposes therefore mentioning this idea specifically.

The Community also is in agreement with the fact that tomatoes have to be firm in this class. It proposes however that this adjective applies to the flesh of tomatoes.

The proposed draft standard mentions that tomatoes must be free from damages (bruises). The Community considers that this is also envisaged by the last subparagraph of paragraph 2.2.1 which stipulates that tomatoes can present only very slight superficial defects.

Lastly, "green backs" type defects (yellow or green aureole located around the stem cavity and which corresponds to a non-edible callous part) have to be avoided in the Extra class. The European Community proposes making explicit indication of it, because such defects are not always easily visible especially when fruits are still at a colouring stage close to green.

Accordingly, the European Community proposes writing paragraph 2.2.1 in the following way:

"Tomatoes in this class must be of superior quality. They must have firm flesh and must be characteristic of the variety as regards shape, appearance and development.

Their colouring, according to their state of ripeness, must be such as to satisfy the requirements set out in paragraph 2.1.1 above.

They must be free from greenbacks and other defects, with the exception of very slight superficial defects, provided these do not affect the general aspect of the produce, the quality, the keeping quality and presentation in the package. "

In paragraph 2.2.2, the proposed draft stipulates that Class I tomatoes are those which do not qualify in Extra Class but satisfy the minimum requirements. Traditionally, Class I products are defined in the Codex standards as "high quality" and characteristic of the variety (including in terms of shape) products. The European Community considers that the proposed drafting no longer describes the gradation which shall exist between classes Extra, I and II products. It proposes therefore taking up again the usual formulation of other Codex standards to define Class I products.

In Class I, the Community is in agreement that tomatoes have to present neither visible "greenbacks", nor cracks. These defects are sufficiently important to be acceptable only in Class II.

With regard to skin defects, the Community is of the opinion that the general rule must be the absence of cracks, healed or not. Skin defects must be limited to slight defects. It does not seem necessary to specify the higher limit of size for these defects. In addition, the higher limit of size proposed for skin defects in Class I seems too important for round tomatoes, oblong tomatoes and cherry tomatoes. Cracks and stem cork-like scars (of umbilical or linear shape) are rather specific to ribbed tomatoes. For this type of tomatoes, specific tolerances can be worked out: healed cracks of 1 cm at most, non excessive protuberances, small umbilicus without suberisation, as well as the defects envisaged by the last indent of paragraph 2.2.2 of the proposed draft.

Lastly, internal discoloration (coffee stain) may be acceptable as a colouring defect provided it is slight. A dimension of 25 mm in diameter (4.9 cm²) is well too important to be described as "slight".

The European Community proposes therefore replacing the second subparagraph of paragraph 2.2.2 by the following text:

"Tomatoes in this Class must be of good quality. They must be reasonably firm and characteristic of the variety.

They must be free of cracks and visible greenback. The following slight defects, however, may be allowed provided these do not affect the general appearance of the produce, the quality, the keeping quality and presentation in the package:

- a slight defect in shape and development,
- a slight defect in colouring,
- slight skin defects,
- very slight bruises.

Furthermore, ribbed tomatoes may show :

- healed cracks not more than 1 cm long
- no excessive protuberances

- **small umbilicus, but no suberisation,**
- **suberisation of the stigma up to 1 cm²,**
- **fine blossom scar in elongated shape (like a seam), but not longer than two-thirds of the greatest diameter of the fruit. "**

- In paragraph 2.2.3 (Class II), no indication is provided with regard to firmness of the tomatoes. The European Community considers that one has to fix a limit and proposes speaking about tomatoes at least "reasonably firm (but slightly less firm than in class I)".

The Community considers that tomatoes presenting unhealed cracks cannot be admitted even in class II, the product being insufficiently conservable.

Allowable defects in class II are numerous and rather important. A number of these defects are not mentioned by the proposed draft such as colouring, development and bruising defects.

With regard to skin defects, one can admit in Class II any defect which does not damage seriously the fruit. But with regard to healed cracks, the European Community proposes fixing the limit at 3 cm rather than 73 mm, because the latter value is well too important with respect to the size of the fruit.

Specific defects for ribbed tomatoes can be the subject in addition of additional tolerance: protuberances, umbilicus, cork-like scars of umbilical shape or of elongated shape.

Accordingly, the European Community proposes replacing the second subparagraph of paragraph 2.2.3 by the following text:

"They must be reasonably firm (but may be slightly less firm than in class I) and must not show unhealed cracks.

The following defects may be allowed provided the tomatoes retain their essential characteristics as regards the quality, the keeping quality and presentation :

- **defects in shape, development and colouring,**
- **skin defects or bruises, provided the fruit is not seriously affected,**
- **healed cracks not more than 3 cm in length for round, ribbed or oblong tomatoes.**

Furthermore, ribbed tomatoes may show :

- **more pronounced protuberances than allowed under class I, but without being misshapen,**
- **an umbilicus,**
- **suberisation of the stigma up to 2 cm²,**
- **fine blossom scar in elongated form (like a seam). "**

Paragraph 3. : Calibration :

- The proposed draft Codex standard for tomatoes fixes a different sizing rule according to whether tomatoes are round or oblong. The European Community understands the proposal as following: for round tomatoes, sizing is by the maximum diameter of the equatorial section; for oblong tomatoes, it is by a double

measure (minimum value of the maximum diameter of the equatorial section; maximum value of the length of the axis joining the stalk at the pistillar end.

This proposal does not specify the sizing rule applicable to ribbed tomatoes. It does not specify size uniformity rules for round tomatoes. They do not specify if sizing has to be applied to trusses of tomatoes. In addition, the sizing scales for oblong tomatoes seem inapplicable: one does not understand how an oblong tomato can be, for example, at the same time of a diameter over 40 mm and of a length less than 46 mm. This sizing scale seems to be made for round tomatoes rather than for oblong tomatoes, since it limits the difference between the diameter and the length of the fruit. Lastly, the proposed size codes do not correspond to any existing commercial practice to the knowledge of the European Community.

- The European Community proposes therefore adopting the following principles for the sizing of tomatoes: size determination by means of the diameter of the equatorial section for all types of tomatoes, minimum size for oblong, ribbed and round tomatoes, size scale applicable to tomatoes in classes Extra and I (other than trusses of tomatoes) without size code indication.

The proposals of the European Community could read in the following way:

"size is determined by the maximum diameter of the equatorial section. The following provisions shall not apply to "cherry" tomatoes.

3.1 Minimum size

For tomatoes classified in the Extra class and classes I and II, the minimum size is set at:

- 35 mm for round and ribbed tomatoes,
- 30 mm for oblong tomatoes.

3.2. Sizing scale

The tomatoes are graded according to the following sizing scale :

- 30 mm and over but under 35 mm (only for oblong tomatoes)
- 35 mm and over but under 40 mm
- 40 mm and over but under 47 mm
- 47 mm and over but under 57 mm
- 57 mm and over but under 67 mm
- 67 mm and over but under 82 mm
- 82 mm and over but under 102 mm
- 102 mm and over

Observance of the sizing scale is compulsory for Extra class and class I tomatoes.

This sizing scale shall not apply to trusses of tomatoes. "

Paragraph 4. : Tolerances :

- Part 4 is different from the general presentation of other Codex standards in two ways:

- on the one hand, the first subparagraph is written in a more complex way without the brought details being necessary since they are included in the traditional drafting of this first subparagraph.

-in addition, paragraphs 4.1.1.2, 4.1.2.2 and 4.1.3.2 envisage tolerances at the transit or point of arrival, tolerances not envisaged in the other Codex standards.

The Community proposes therefore suppressing paragraphs 4.1.1.2, 4.1.2.2. and 4.1.3.2, and writing the first subparagraph according to the following traditional formula:

"Tolerances in respect of quality and size shall be allowed in each package for produce not satisfying the requirements of the class indicated."

- Tolerances proposed in paragraphs 4.1.1.1, 4.1.2.1 and 4.1.3.1 are 10%. It seems more suitable to the European Community to fix less high tolerance for the Extra class in which only tomatoes of superior quality shall be classified. In addition, in each class, only produce of the category immediately below are usually tolerated. Tolerances are provided for avoiding that small mistakes of classification involve the downgrading of the whole lot in its integrality. The European Community fears that, enlarging tolerances too much, it becomes a pretext to systematically include out of grade fruits, even in Extra class or Class I. Lastly, it is necessary to avoid any product not fit for consumption, in particular those affected of rot at a point where consumption is impossible.

In addition, since an increasing share of the trade is done in the form of trusses of tomatoes, it is appropriate to envisage specific tolerances for these products.

Accordingly, the Community proposes writing paragraphs 4.1.1, 4.1.2 and 4.1.3 in the following way:

"4.1.1 Extra class :

5% by number or weight of tomatoes not satisfying the requirements of the class but meeting those of Class I or, exceptionally, coming within the tolerances of that class.

4.1.2 Class I :

10% by number or weight of tomatoes not satisfying the requirements of the class but meeting those of Class II or, exceptionally, coming within the tolerances of that class. In the case of trusses of tomatoes, 5% by number or weight of tomatoes detached from the stalk.

4.1.3 Class II :

10% by number or weight of tomatoes satisfying neither the requirements of the class nor the minimum requirements, with the exception of produce affected by rotting, marked bruising or any other deterioration rendering ot unfit for consumption. In the case of trusses of tomatoes, 10% by number or weight of tomatoes detached from the stalk.

- With regard to size tolerances, the European Community proposes that one limit tolerance for tomatoes smaller than the minimum size, by adding the following sentence:

"... with a minimum of 33 mm for round and ribbed tomatoes, and 28 mm for oblong tomatoes"."

- The European Community considers that setting colour tolerances is not necessary in paragraph 4. Colouring defects are included within quality tolerances. With regard to the absence of uniformity in colouring for a lot or for a package, the question has to be addressed within paragraph 5.1 (uniformity) and not within paragraph 4 which deals with defects one can tolerate for each individual fruit. The European Community proposes therefore suppressing paragraph 4.3.

Paragraph 5. : Presentation :

- According to the proposals of the European Community made in paragraph 3, sizing of tomatoes would be compulsory only for the Extra class and class I. Size uniformity is therefore due only for these two classes and not for the class II. The European Community proposes therefore adding the following bracket to the end of the first sentence of paragraph 5.1:

"(if sized)"

- For class I tomatoes, which are of good quality, certain colour and maturity uniformity has to be satisfied according to the European Community. If the trader who orders class I tomatoes (good quality, but not superior quality) receives tomatoes of all colours and state of ripeness mixed in the package, he will have to, without any doubt, carry out a new sorting, which appears contradictory with the concept of good quality. In addition, in the case of oblong tomatoes, it is appropriate to fix certain length uniformity for the two higher classes. The European Community proposes therefore the following text to replace the second sentence of paragraph 5.1:

"The ripeness and colouring of tomatoes in Extra Class and Class I must be practically uniform. In addition, the length of oblong tomatoes must be sufficiently uniform."

- Footnote 4 in paragraph 5.2 (Packaging) stipulates that recycled materials could be used inside the packages. In commercial practice, only packages themselves are recycled, not materials used inside the package (plastic crates for example). The recycling of this type of materials should not be incited or urged, because, in general, these materials are not re-usable. Accordingly, the European Community proposes deleting Footnote (4) in the proposed draft Codex standard for tomatoes.

- The commercial practice which consists in presenting the tomatoes in trusses developed enormously during the last decade. The European Community wishes therefore a new paragraph 5.4, named "Presentation", to be inserted in the proposed draft in order to describe the two methods of presentation of tomatoes. In particular the presentation in trusses shall be described, which, having regard to the better remuneration the market gives for it, could be the subject of fraudulent practices. The European Community proposes the following text for this new paragraph:

"5.4 Presentation

The tomatoes may be presented as follows:

- as individual tomatoes, with or without calyx and short stalk;
- as trusses of tomatoes, in other words, in entire inflorescence or parts of inflorescences, where each inflorescence or part of each inflorescence should comprise at least the following number of tomatoes :
- 3 (2 if prepackaged) or
- in the case of trusses of "cherry" tomatoes, 6 (4 if prepackaged). "

Paragraph 6. : Marking/ Labelling :

- At item 6.2. (Non-retail containers), the proposed draft Codex standard for tomatoes stipulates that particulars set out by sections 6.2.1 to 6.2.5 could only be present in documents accompanying the shipment. This possibility is traditionally reserved for bulk (in a transport vehicle or part of a transport vehicle) shipments. Tomatoes are not shipped this way. Accordingly, the European Community proposes deleting the following words : ", or in the documents accompanying the shipment".

- In paragraph 6.2.2, the proposed draft sets out the marking of the nature of produce when the contents of the package are not visible from the outside. The European Community considers that, in the case of trusses of tomatoes, this indication, as well as that of the commercial type (round, ribbed, oblong) has also to be indicated. In addition being given their very different characteristics, cherry tomatoes should be the subject of a compulsory marking. The text of paragraph 6.2.2 could be as follows:

"" tomatoes "or" trusses of tomatoes "and the commercial type if the contents are not visible from the outside. These details must always be provided for "cherry" (or "cocktail") tomatoes, whether in trusses or not.

- name of the variety (optional). "

- Paragraph 6.2.4 stipulates that the size is indicated either by the code (see paragraph 3), either by the average diameter. Since the European Community proposes the removal of the codes referred to in paragraph 3 (the latter not being used in trade) and that the standard fixes no size uniformity rule based on an average size, the European Community proposes rather indicating the size (if tomatoes are sized) by means of the minimum diameter and the maximum diameter in the package.

Paragraph 7 : Contaminants :

- Paragraphs 7.1 and 7.2 refer, as well as all other Codex standards for fruit and vegetables, to the maximum limits fixed by the Commission for heavy metals and pesticides. Without contesting this principle, the European Community wonders however if the Codex standard for tomatoes (as well as other Codex standards for fruit and vegetables) would not gain in legibility and in transparency by incorporating a summary table of these maximum limits fixed by the Commission.



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Dr. Krassen Stanchev *

Gypsy Contribution to Prosperity and Capitalism in Bulgaria¹³

Abstract: *The paper makes an attempt to argue that understanding Gypsies (or Roma) as a group of deprived individuals and/or as a minority that requires specific policy action is at least not corresponding to the reality. This is the conclusion based on history of Gypsies in Bulgaria, in the second half of the twentieth century.*

The first part of the paper deals with the socio economic function of Gypsy entrepreneurs in the years of the late Communism, especially in the years after 1975. It describes how they were involved in complex international exchange and, thus, contributed to pockets of prosperity of those years, irrespectively the fact that most of their undertakings were formally criminal. This role, although confined to the shadow economy under the central planning, led to a specific success of the individual Gypsies, be they entrepreneurs or ordinary citizens, after the political and economic reforms of 1989. This part of the story is the subject matter of the second part of paper, and it deals Gypsies contribution to property rights definition, development market institutions and political culture.

Key words: *Gypsies, entrepreneurship, capitalism, market institutions, communism*

Resumee: *Mit dieser Arbeit versucht man, zu beweisen das die Wahrnehmung der Roma (Zigeuner), wie eine Gruppe geringwertiger individueller und/oder wie eine Minderheit, die erfordert eine besondere Behandlung in Bulgarien, in kleinster Weise, entspricht es nicht der Realität. Das ist die Schlussfolgerung basierend auf der Geschichte der Roma in Bulgarien in der zweiten Hälfte des 20. Jahrhunderts.*

Im ersten Teil der Arbeit analysiert man die sozioökonomischen Funktionen der Roma Unternehmer in der Zeit vom späten Kommunismus, vor allem nach 1975. In der Arbeit wird gezeigt, wie sie beteiligt wurden in einem komplexen internationalen Austausch, was zum Teil beigetragen hat für den wirtschaftlichen Wohlstand in einigen Bereichen, trotz der Tatsache, dass die Mehrheit ihrer Aktivitäten formell behandelt wurden als illegal und "kriminell". Diese Aktivitäten sind, unabhängig davon, was man verbindet an die Schattenwirtschaft im Rahmen der zentralen Planung hat es beigetragen zu den Erfolg des Einzelnen aus der Roma-Bevölkerung, wie auch Unternehmer so auch einfachen Bürgern, nach der politischen und wirtschaftlichen Reformen 1989. Mit dem beschäftigt sich der zweite Teil von der Arbeit, der analysiert den Beitrag der Roma in der Definition von Eigentumsrechten, Markt-Institutionen und politischer Kultur.

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¹³ This paper was written for internal discussion of Open Society Institute's in Sofia, also known as "Soros Foundation" of "Open Society" working group on Roma Inclusion, in 2005. It was inspired by my almost simultaneous work on a Property Rights and Economic Performance in the Balkans (An Overview with a Reference to Bulgaria) – a discussion paper for the Liberty Fund Symposium on "Private Property Rights and Liberty" held in Dallas, November 16-19, 2006, and organized by Professor Emeritus of Texas A&M University Steve Pejovich. A shoetree version of this paper was first published in English in IME's Economic Policy Review, Vol. 6, No 37 and 38, 2006; a series of newspaper articles appeared in 2005 in the Bulgarian press, the most complete of those were the publications in the daily *Dnevnik* (www.dnevnik.bg).

Резюме: *Статья делает попытку обосновать, что взгляд на цыган (или Рома) как на особую ущемленную в „социальных правах”, или как на меньшинство, чье общественное положение требует специфической политики для восстановления этих прав, в лучшем случае не соответствует действительности. Это заключение обосновывается опытом болгарских цыган во второй половине XX века.*

Первая часть статьи посвящена рассмотрению социально-экономических функций цыганских предпринимателей в последние годы коммунизма, в частности после 1975 года. Она описывает, как цыгане были участниками сложного международного обмена и таким образом внесли свой вклад в спорадически возникшие элементы процветания Болгарии в те годы, независимо от того, что им предпринимчивость была формально криминализована. Эта роль, хотя и представленная преимущественно в отношениях серой экономики в условиях центрального планирования, привела к особому успеху отдельных цыган, как предпринимателей, так и обычных граждан, после политических экономических реформ 1989 года. Эта часть истории является предметом второй части статьи. Она обсуждает роль цыган в определении прав собственности, в развитии рыночных институтов и в становлении новой политической культуры Болгарии.

Introduction

The key difficulty in resolving Gypsy integration challenges in the EU and in Bulgaria is the lack of thinking about Gypsies as normal individuals.

They are perceived by different governments and Brussels programs as, on one hand, “betrayed and oppressed” (in the human rights rhetoric), “isolated”, “ostracized”, “segregated”, “discriminated” or as, on the other hand – by left and right policy moods alike, as “rough”, “stealing”, “under-culture”, “non-civilized” and even “not-subject-to-civilization”, to refer just to a few of the Bulgaria public opinions, somewhat subtitled clichés.

Respectively, the required policy “towards them” should be one of “inclusion”, “integration”, “rehabilitation”, “support”, “education” and “protection”. This is the vision of the said programs, including private and quasi-government, UN and EU “charities”. The common denominator of all these definitions is the interpretation taking Gypsies, or Roma as a class, as category of the population but not as individuals.

Alternatively and again reading Roma as a class, although not quite politically correct, a majority of the public opinion in Bulgaria, Czech Republic, Slovakia and Serbia or Kosovo believes that Roma are the societal “bad guys”, those who steal, who are per se criminal, relief seekers, welfare users and basically under-class and under-dogs. But this thinking, too, takes Gypsies as a group, ethnic entity; and the

features attached to the group are usually immediately attributed individual Roma, whatever his or her occupation, religion or residence is.

Listing Bulgaria first is no accident or alphabetical order of countries. Bulgaria has the largest share of Gypsies in the citizenry, perhaps, around 7-8% of the population, and it has a party represented in the legislature, that campaigned in 2005 with a slogan (among other slogans) "Gypsies – on Saturn!", which in Bulgaria sounds like "Gypsies – on Soap!". (The word for "soap" in Bulgarian is "sapun" – from Turkish; so, when "Saturn" is shouted it sounds as "soap".) In reality, according to anthropologists and sociologists – Bulgaria anthropologists are really very good by any scientific standard, especially on Gypsies – the Roma in the country are very different: few them are nomads, many are Muslim, quite many but somewhat less are Protestant (they live most often in the biggest cities) and/or Catholic – located *en mass* in few regions, and some are Greek, perhaps Vlachs, or ancient Romanians, they are blond-haired and specializing as sheep breeders. Anthropologists claim that altogether there are eight distinguished groups of Roma in Bulgaria, differing from one another by culture, habits, religion and appearance.

I shall discuss here the ways Gypsies used to contribute and contribute to the economic life and prosperity of Bulgaria. I am convinced that these ways are similar in other countries mentioned above and that the problems of the so-called "Roma Inclusion" are poorly and serve the interest of those who implement these programs. The prime source of this paper is my own experience as teenager and student in the 1970's, my personal encounters with Gypsy compatriots as a member of parliament in the early 1990's and my work as a director of the Institute for Market Economics (www.ime.bg) and economist during the crisis of 1996-1997 private initiatives to provide micro credits to Roma entrepreneurs.¹⁴

I start with an attempt to describe how representatives of the Roma contributed to the prosperity on the Bulgarian society under Communism, how they helped create Capitalism (this role that stems from Communist times) and what was and still are the role of Roma in shaping Bulgaria's democracy, culture and policies. I start here with the late Bulgaria Communist years, reviewing some exclusive benefits no one in the country could supply but Roma entrepreneurs.

Gypsies and the Free Markets under Communism

¹⁴ After the first article in *Dnevnik* (*Dnevnik*, May 8, 15, 2005), Professor Petar Emil Mitev – the doyen of Bulgaria sociology – told me in a that my observations coincide with the findings of 1980's surveys of Gypsies by the Institute for the Study of Youth of the Central Committee of the Bulgarian Communist Party; he asked me also whether I have copies of those surveys, because they were commissioned by the Ministry of Interior in mid-1980's and were classified (and he, as a director of the Institute had no copy; the Institute of Youth was closed in 1990 and he believes the archives have been lost)..

Second hand clothing and cooperative agriculture

Before 1980, the city Roma craftsmanship was rather typical: blacksmiths, chimney-cleaners and specialists in repairing lead and non-ferrous metals articles. One typical Gypsy profession, however, is today totally forgotten: old city Gypsy men were almost the only in the country purchasers of second hand clothing, they wandering around towns' better off neighborhoods on weekend mornings, shouting "Old Cloths 'Buying'".

In those years the second hand clothing exchange was functioning only among relatives; in Bulgaria, almost like everywhere, they used to exchange baby and kids' dress. Those were times of widespread shortages. Re-making adult clothing was still somewhat popular, but that was the market for professional tailors while many people, not only female but male, including myself, were capable of performing simple tailoring and had respective sewing machines at home to remake old dress or pants, or jeans.

The very old clothing, however, was in demand among Gypsies only; no one would give cash for that in the 70's and the 80's for such clothing in those years of the last century.

In the 1990's, selling second hand clothing had become a formalized and even international business.

As far as I could recall, in the agriculture nomad Gypsies were welcome seasonal workforce.¹⁵ The eagerness of cooperative farms to hire them was motivated by the chronic shortage of farm workers, especially because "brigades" of pupils and students were creating more mess than value added in the fields and gardens. There was no discrimination: the day pay was equal to the normal one, the difference between urban "brigadiers" and the Roma was that the latter could work and actually worked hard, to support the family.

Early birds of market economy

Management of independent supply channels of forged or smuggled goods in time of shortages, however, was the true employment for the city Gypsies in the late of the 1970's Bulgaria and the capital city of Sofia in particular. It was preceded by the liberalization of movement of people in ex-Yugoslavia (after 1965) and the

¹⁵ My Western readers may not know that in my and other Communist countries large, virtually all groups of urban populace was required to "volunteer" few days or a week per annum to work in the agriculture; pupils and students used to "volunteered" for at least a month.

spontaneous open-air market for consumer goods and fashion articles at Sofia St. Alexander Nevski Cathedral Square, the very heart of the downtown area. Yugoslavs were trading those articles, music plates and magazines, erotic journals and anything one would imagine or desire. That market expanded during the World Communist Youth Festival of 1968, which took place two – three weeks before Warsaw Pact troops invaded Czechoslovakia. Suddenly, it practically declined and moved to another location in 1972 when Belgrade and Nis (a town in Eastern Serbia) bus stop was moved to the outskirts of the city.

On the main Sofia Alexander Nevski Square “black market”- as it was called then although it was virtually the only normal market place in town, the Roma did not compete with Bulgarian spontaneous merchants who wanted to buy and resell to the local thirsty public; they wanted to sell to ex-Yugoslavs things that were much cheaper (subsidized) in Bulgaria – milk and milk products, cheese, etc. The Roma were saving the ex-Yugoslavs the costs of walking around empty shops, of queuing and other unpleasant experiences.

Gypsy foreign exchange services

How only very few would remember that in the Communist countries there were special shops where foreigners, tourist, diplomats and privileged domiciles alike could spend their hard currency. In Bulgaria they were called “*Korecom*” – from “currency commerce”, thus indicating that local “money” was anything else but currency.

The supply channels of valuable goods managed by Roma entrepreneurs merged in relation to “*Korecoms*” and paralleled them. They flourished and prospered especially after the “*Korecom's*” liberalization of 1977 that consisted in the fact that the government suddenly stopped asking questions about where the public has the hard currency from. Of course, nothing was certain but, obviously, the Communist planners needed dollars, D-marks and every other useful cash to finance big ideas and pay debts to Moscow and Western countries; new borrowing was problematic in the early 1990's and the authorities had no option but collecting this cash from the public.

The circumstances were the following:

- The fear of visiting those shops¹⁶ did not disappear; many people, however, were trying their best to overcome it;
- The demand for hard currency had risen; the official exchange rate to the US dollar was about 1:1 but on the free market it was 3-4 to 1, often higher for Soviet Union (the shortages there were much more severe and unbearable) and/or for smaller quantities;
- An organized but informal market for goods demanded against hard currency emerged.

The Sofia Gypsy community services in this situation were very much the ones at a state of the art:

- Foreign exchange, currency trading;
- Import of most demanded goods – jeans, cloths, cosmetics, modest and easy to carry devices like radio, tape recorders, gramophones, sewing machines, skis and ski boots, etc.;
- Diversifying the intermediation depending on the conjecture and the good at demand;
- Visiting the shop for instead of the frustrated buyer.

The money markets were located in front of the “*Korecom*” shops to serve desperate shopping public or smartly downtown, in front of the Central Department Store – next to the Council of Ministers building and across the square from the president's office. It was rather clever to meet disappointed customers of the Central Department Store when they walk out empty-handed and offer them some alternative place to buy what they wished.

The currency trader would usually ask what the good the unfortunate needs to buy is. If it was clothing, jeans or any other of the above said goods, the Roma entrepreneur would usually offer a better price than the official currency shop if it was to be bought at another location”. If it was skis or something that would be relatively difficult and risky to store, the service would be to buy that rather expensive piece at the hard currency shop instead of the customer but in his/her presence to help with his or her fear of being asked about the origination of the hard currency.

¹⁶Beside “*Korecoms*” there were shop chains for those who possessed Russian ruble denominated coupons (those who worked in the Soviet Union) and shops for sailors, but in those shops buyers were required to identify themselves or prove the source of the money – not always but often.

This "other place" usually was the Gypsy neighborhood at the outskirts of the city, the taxi (another to severe shortage in those years) was readily available, often at the expense of the seller. The goods were usually stored in a relatively well-to-do house. The quality was expected to be the same as in "Korecom" and one could try the cloths that were properly packed and labeled. The taxi would save time to go there and back, if the purchase was significant and the company pleasant the merchant would pay the taxi. The transaction should have been executed in hard currency, which usually was to be provided, exchanged by separate vendors.

I am not aware of a single case of a fraud. In comparison to the trade in the "Korecoms" and especially to the exchanging money on the street with Bulgarians, the risk was zero. The militia in front of the Central Department Store would witness what was going on but would not interfere. The Roma vendor would, as a rule, know the caps.

Servicing the customer

In all three cases there is one very significant role of the Roma entrepreneur: he (women were not involved) was helping to overcome severe shortage of the Bulgaria's Communist economy.

In the shortage economies witness a very widespread phenomenon, the consumer surplus was driving the prices like in normal economies but with some excesses.

Thanks to the controls and oppressed competition, the consumers valued some goods far beyond their price under other, normal conditions. That price paid would appear high relative to the opportunity costs or compared the wages and income.

Some examples: in 1977-1979 a pair of jeans in "Korecom" could typically cost from 21 to 27 US dollars and the price was equal to 1/5 – 1/4 of the average salary. But outside "Korecom" the jeans price would be most likely 35 – 40 US dollars. With the Gypsy jeans vendor the pair price was equal to the one in the shop or often a little bit less. The same was the case with other desired goods.

In other countries, the constellation was similar but there were no Gypsies involved in the trade. In some countries it was even more desperate but provided for normally unthinkable arbitrage.

In Leningrad, today's St. Petersburg, the price of a pair of jeans in 1977 – 1979 was 125 US dollars – almost two times the average salary. In the Soviet city of Tolliatti one could sell a pair for US 250 dollars. It was four times the average salary but two times the average wage in that city since it was producing *Ladas* – for those who do

not know, it was the Soviet car being sold throughout the countries of the Eastern Block. But the circumstances could endlessly differ in details. For some reason, in 1975, Leningrad authorities banned Finnish tourists of using their own currency in bars and the Soviet analogue of “*Korecoms*”, limiting also the amount they could exchange officially. Poor Fins could only exchange their money at 1/4 of the market rate or risk buying nothing from this suppressed but otherwise cheap vodka market. Then, in Finnish currency, perfectly usable on the hard currency market in Bulgaria and elsewhere, the pair of jeans could cost in fact about 7 US dollars and be sold in Leningrad or Tolliatti for the above price. The market worked smoothly; there was some risk of being caught by the Soviet custom authorities but the reward for taking the risk was really attractive.

In 1960's and 1970's people were not looking just for bread and butter but for something more, beyond the established and planned basic needs.

How did the Gypsy entrepreneurs used to fall in the picture? They served the consumer. Many Bulgarian students in Soviet universities, actually thousands of them, lived better than many ordinary Soviets and Bulgarian for years.

Contribution to prosperity

The Gypsy entrepreneurs have been helping ordinary Bulgarian citizens for years doing what the system was not providing or was even fighting against. In the described three cases we have obviously dealt with:

1. Exploring and developing a market for goods and services for which even an attempt by the majority representative would have been punishable or morally condemned but which allowed Gypsies help others in receiving what they wanted;
2. This activity had nothing to do with the social welfare system of that era and the Gypsies involved were helping themselves much better compared to what they could have gotten under the welfare;
3. Not only the flexibility of income but also the mobility of labor was secured under Communism with the Gypsy assistance. It was especially visible in the agriculture;
4. Being an intermediary or an entrepreneur was a crime during the Communism, Gypsies obviously managed to counteract the ban and serve the consumer surplus of many individuals, whose rights as customers were systematically oppressed by the government.

Needless to say, in all three cases these activities were performed not only by Gypsies. The important point, however, is that they were doing this on a more

massive scale and as a profession. There would be no exaggeration to state that in the Communist Bulgaria of 1970-1980's it was the single largest segment of the population that was living in and intermediating niches of the free market under the totalitarian oppression of the central planning.

Gypsies and the Rebirth of Capitalism in Bulgaria

From a societal stratum with most pro-market economic behavior, Bulgarian gypsies, after 1989, have become a key reform agent although this role has never been properly reflected and explained. In this article I would like to discuss the specific niches they occupied in the last 16-17 years, how they were influenced by the culture and how they were motivated by outside factors and welfare state incentives. As in the previous article, I speculate on and attempt to offer an interpretation of well-known facts and developments without pretending to be empirically rigid. I am confident that a specialized survey is likely to provide sufficient hardcore evidence to the interpretation I offer.

Definition of property rights with the help of Gypsies

Gypsy entrepreneur: a bare foot capitalist

At the eve of the late 1980's reforms, the Gypsy population of Bulgaria had played an important role. Before the political reforms of November 1989 - June 1990 (the political crisis of the Communist regime and the first free post-Communist elections), the regime had loosened its' grip on the economy allowing private individuals to establish individual small businesses in the services and other sectors.¹⁷

In countries with oppressed individual rights, small changes lead to significant unintended consequences. The gypsy business in the late 1970's and 1980's have contributed to two key justifications of those partial reforms: they have demonstrated that private initiative is not subject to eradication, that it flourishes in all societal strata and that it produces prosperity gains on all levels.

In the economy the key manifestation of private property right is the right to be a consumer, a master of own preferences and the choice to buy what is wanted from whom it is wanted and at a price that is freely negotiable. The consumer surplus drives this right even under Communist conditions. This phenomenon is well

¹⁷ That partial liberalization was launched by the Decree 56 of 1989 (titled "On Citizen's Economic Initiative") that prescribed how companies are to be registered and what taxes they pay.

discussed in the literature¹⁸ as we have discussed this role of Bulgaria Gypsies in the previous sections of this paper. The institutional side of the consumer surplus is that it helps in searching and establishing the link between production and consumption: under normal conditions, if consumers do not need certain goods and services then the producer does not have other prospect besides closing production.

These “normal conditions” are well-defined individual rights to private property and consumer choice and absence of coercion and plunder. Under the system of central planning and limited to homes and small plots of land private property, as was the situation in Bulgaria between 1948 and early 1989,¹⁹ all forms of servicing consumer rights were forms of a deconstruction of the status quo (while private business has been effectively treated as crime in all walks of life until early 1989 when the prohibition was partially lifted from some sectors). Although entrepreneurship and such deconstruction was criminalized, it performed the following important functions:

- Definition of the limits of central planning ,
- “Creation” and sustaining alternatives to central planning,
- Destruction of the central planning, since consumer surplus motivates plundering from state owned assets.

In this situation, the Gypsies in Bulgaria were the only societal group to fulfill the above said deconstruction; other groups were performing it by accident and on a sporadic basis. This is because the Gypsies as a group were:

- Deprived of social status, career and influence,
- Completely pauperized, a “proletariat with any avant-garde”,
- Group market economy actors under Communism.

The liberalization of the hard currency shops and trading in 1970’s with the spontaneous involvement of Sofia and other big city Gypsy communities performed

¹⁸ See: Mansur Olson, *Power and Prosperity*, New York, Basic Books, 1998, William W. Lewis, *The Power of Productivity*, Chicago, Chicago University Press, 2004.

¹⁹ In Bulgaria, the “excessive ownership” of homes (flats and houses) was nationalized (in 1947-1948); in fact there was a rationing of this type of property. However, during the entire communist period private homeownership was comparatively high – 80—85%, the urban population retained full ownership of their houses in the rural areas and the plot of land around them (40-50% of the urban population has had such ownership); the ownership titles on arable land, forest, etc. remained private but the use of land was “collectivized”, more or less completely after 1962 while the forest was nationalized. Totally expropriated were about 4,500 – 5,000 families. One of the key reforms after 1989 was the restitution of all types of ownership – see: Krassen Stanchev, *Denationalization in Bulgaria*, in: Krassen Stanchev (editor), *Contemporary Economic Libertarianism in Bulgaria*, IME, 2004, available also at: www.easibulgaria.org and in other reprints.

an example of barefoot capitalism. Such capitalism was, however, not only a mercantilization of shortages of highly valued goods as jeans. Besides the already mentioned specific craft niches and agriculture free-lance, an even more important market role of the Gypsies was their involvement in the creation and functioning of the early 1980's open air bazaars of "Iliantzi" and "Malashevtzi".²⁰ Both were the first officially recognized (not disturbed) alternatives of scale to centrally planned retail trade and distribution. These markets began opening at first on weekends but soon the volume of trade necessitated daily operations, seven days a week.

In early 1989 and then after political changes of late 1989-early 1990 and with the start of the economic reforms of 1991 such markets grew in size and spread around the country.²¹

Later, the role of the Gypsies as a group of almost exclusive bazaar operators gradually faded away. They were substituted by other "foreigners", Arabs, Afghani and Palestinians who were settling in Bulgaria on their way to Europe or who had chosen not to go back to their countries since Bulgaria offered better prospects. This was the same phenomenon of barefoot capitalism but more international and globalized as not only the goods but the merchants and buyers were from many different countries. (In 1991 and especially in 1992, after the outbreak of the wars in ex-Yugoslavia and embargoes on Macedonia and Serbia, the bazaar become an international trading place.)

From this moment on, a new specialization has begun of bazaar Gypsy intermediaries.

In 2000 and 2001 Prof. Julian Konstantinov observed with criticism the operations of the Gypsies on "Iliantzi" market and on a similar bazaar in the town of Dimitrovgrad. He found that in those markets there was a special additional service offered – fake invoices, and that this service was totally dominated by Gypsies.²²

²⁰ Both are named after villages, which in the 1970's have become Sofia districts.

²¹ Immediately after political reforms of 1989 and first free post-Communist elections of June 1990, Bulgaria has been a successful market reformer, at (then) best Central European standards for such reforms; it happened between December 1990 and the fall of 1991 when reforms were first somewhat delayed due to elections and eventually stopped in late 1992 due to a political crisis, which led to electoral victory of the Socialist in 1994 and their attempt to restore central planning in 1995 and 1996.

²² Julian Konstantinov. Kam formalisirane na sivata ikonomika v Bargaria? (Targovtzi na otkritite nazari). Dokrad of terenno prouchvane iuli-avgust 2001. - Evgenii Daynov (redactor). Sivata Ikonomika v Bulgaria: prichini, sledstvia, politiki, Sofia, Tzentar za sotzialni praktikiq 2002, str. 83-84 I sl. (In Bulgarian, the English title: Julian Konstantinov, On the Formalization of the Grey Economy in Bulgaria: Open Air Bazaar Merchants, (A Report from a Field Servey), in: Evgenii Daynov (editor), The Grey Economy in Bulgaria: Reason, Consequences, Sofia, The Center for Social Practices, 2002, p. 83-84 a.f.).

Those were (are) not invoices for the goods purchased on the market. The service is issuing invoices for tax reporting on a desired amount of money (but not 5-6 thousand US dollars) against 1% of the book price (or a lump sum).

Mr. Konstantinov complains that the invoice trading by “mostly Gypsy” vendors takes place before the indifferent eyes of the street police on the market, especially in Dimitrovgrad. At the end of the day, however, such invoices were in great demand as a salvation from counterproductive tax regulations: the marginal tax rate in 2000 and 2001 was 65% for a medium size entrepreneur and the regulatory system was characteristic with its harassing controls over private enterprise.

Copyrights promoter in hard spirits

Copyrights and patent protection used to be one of the key problems of the Bulgarian economy in the beginning of the 1990's. The legacy of the Communism in this area is that those rights are relatively well established in high tech and scientific fields but almost non-existent in trademarks in food processing, pharmaceutical, perfumery and wine industries. More specifically, they existed on paper but the actual implementation and protection did not present a problem in Communist years due to the state ownership of enterprises and government monopoly on wholesale and retail trade.

In the early transition years it was generally quite easy to enter those markets, especially the wine and spirit industry.

Gypsy entrepreneurs, some of whom served the hard-currency-shops trading in 1970 and 1980's, somehow naturally directed their ingenuity towards those markets.

Production of fake alcoholic beverages by mostly Gypsy vendors has had at least three positive impacts:

- They dismantled and eventually expropriated the state monopoly on the production of fake alcohol , which existed for years undisturbed and flourishing as part of the centrally planned “ wine - proms ”; notably, the Gypsy vendors produced fake wines and hard spirits at quality levels that were comparable and even better than those of the state wine industry;
- Hard spirit and wine lovers with relatively low purchasing power had the opportunity to tastes they could not afford otherwise ;
- The fake production had eventually forced formal “vinproms” implement quality controls systems, consumer information, apply brand controls and rationalize production and marketing.

There were other factors that supported development in this direction – privatization of the wine industries (although somewhat delayed) and establishment of sectoral self - regulatory bodies in 1999 in addition to the opening of the retail markets to large retail chains (Metro, Billa) and so on. But the Gypsy vendors were the first to identify the niche and to challenge the government monopoly. Today it is possible to argue that there were better and more civilized ways to push for reforms but I can hardly imagine any reforms emerging by themselves, given the government reluctance to privatize wine industry that was common for number of governments before 1997.

This industry was viewed as a “strategic one”, as a “core Bulgarian comparative advantage”, and from these notions the, mostly Socialist, government derived the “justification” to postpone privatizations until 1996. The actual disagreement with the production and marketing of fake alcoholic beverages stemmed in those years from the fact that someone else is doing the same business as state owned wineries. The state monopoly lasted for more than forty years. “Tzar Kiro” – the most famous Gypsy vendor in fake spirits, although it is rather a nickname - has been in this business for not more than four years.

A part of the production concepts are now in the hands of formal wine producers, they continue selling healthy drinks at low price.

Nature produce collectors, determinants of “public goods” and aid addiction

The definition and redistribution of property rights through privatization has been slower in Bulgaria than in other countries.²³ Particularly unclear those rights remained in the area land ownership (the restitution proceeded between 1991 and 1998, and some instances of collective use were sustained). Simultaneously, the redistributionist policies via “social benefits” and “social aid” during the same period were particularly non-transparent and unreasonable and to a large extent remain unreformed even today.

In this respect is one of the most important, positive but publicly controversial role of the Bulgarian Gypsies in the transition.

By ways of culture and due to social status they collect everything that is not properly collected but could be of some use. These could be trees and wild mushrooms in the forests, garbage paper, metal scrap, electricity distribution wires, street sign, maternity “benefits”, “social aid”, heating subsidies for poor families, electricity bills and anything else.

²³ For details, see: Krassen Stanchev , op . cit.

Public “goods” do not exist per se. Some of those could be seen as public when and if they are available for everybody’s use amidst little or costly opportunities to exclude free riders and punish them.

In general, what is not protected as belonging to someone is not valued. The Bulgarian press and public opinion blame “The Gypsies” for the utilization of such public goods.

The actual constellation is very different and the Gypsy collection is:

- Of great significance for the determination of the value of the properties that were either privatized or returned to previous owners but remained unprotected for a certain period of time; in cases where the private property was reestablished but remained unattended, the Gypsy collectors motivated owners to be vigilant and organize protection on their own, to the extent it happened the Gypsy collectors, as a rule disappeared from the sight;
- Completely in the normal course of the events and in the framework of the law when they benefit from otherwise useless government programs ; racist politicians and members of the public usually blame “ the Gypsies” but, in fact, Not He is to be Blamed Who Eats the Cabbage Cake – That’s the One Who Gives It, as Bulgarian saying goes;
- Very useful for the separation of the urban waste and for its recycling; for the time being, the latter is almost not at all common practice in Bulgaria; for this reason the quasi-industrial separation is done manually and sold to recycling companies; with the gradual industrialization the Gypsies would be forced out of this niche;
- With regard to metal constructions with public functions and the alleged habit of Gypsies to collect those as the Bulgarian press claims (i.e. metal element of sewage facilities, street signs and electric wires), it needs to be mentioned that it is typical only for Bulgaria, although Gypsies live in other countries as well. The key explanation here is that there is a regulatory problem related to the oversight on scrap buyers and recycling plant: they buy such metal articles that should normally be not subject to recycling;
- Perfectly legitimate with regards to natural produce of forests (mushrooms, wood , herbs , etc .) – the ownership of the forest is 85% public and poorly regulated while there is a significant demand for wild mushrooms and herbs by respective industries in Bulgaria and abroad.

I think it is obvious that none of the above instances represents a violent expropriation. There were clashes between restitution landowners and Gypsy collectors but they quickly disappeared when owners began protecting their properties and production.

The positive role of the Gypsies

The eventual impact of the Gypsy collection is that it caused a spontaneous effort to protect land and agriculture production by vigilant farmers and guards hired by farmers. Similar was the story with common village properties, trees and fields. When those are not protected Gypsies and everybody else could reap the harvest and sell it to the market.

Similar is the case with "Gypsy" crafts, they produce knives, axes and other metal instruments. The raw material inputs are basically collected entirely from the garbage litter. It takes time to do this job and it is far from pleasant but the unemployment is high, the labor cost is very low and often craftsmen have the family and friends taking care of the supplies. The human capital and the skills to produce the instruments also come from tradition and family. The cash is needed for the fuel and coal. As I know from a survey of informal credit I conducted in 1996 and 1997, these costs are roughly \$ 500 a year. There are schemes to reduce them: use heating subsidies provided by the government in coal or wood or alternatively, collect wood in the forest where and if possible.

As in all cases of collection, there is a use of resources that otherwise are neither valued nor used and they are put into service someone benefit or further converted into capital.

The misunderstanding

The lack of normal understanding of Gypsies' ways and days in the last sixteen years of Bulgaria history are typical for the Bulgarian press, the public opinion and newly emerged chauvinist political parties. More importantly, however, they are misunderstood by the agencies and policies to support "Gypsies". The most common development in this respect is the aid addition on behalf of the donor. If Gypsies take care of themselves, as they have proven they can over years, the "benefactors" will be forced out of job.

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Igor Lukšić*

Austrian Explanation of the Crisis

Abstract: *Economic crisis suggest world economy reach high level of being globalized. Though not yet a single world market, technological advancement and economy intertwined inevitably affects all the market participants. At the same time, it is possible to identify fast money supply expansion of different forms to be in the roots of the crisis leading to quick inflation of various asset prices. In the context of Montenegro, one could scrutinise economic crisis by applying findings of the Austrian school of economic theory of business cycle to it. The threat to the achieved level of the globalized world economy is in reappearance of different forms of protectionism.*

Key words: *crisis, business cycle, globalization, Austrian school*

Resume: *Die Wirtschaftskrise weist ein hohes Globalisierungsniveau der Weltwirtschaft auf. Obwohl der einheitliche Weltmarkt nicht vollkommen abgeschlossen wurde, deuten der technologische Fortschritt und die wirtschaftliche Verflechtung auf unvermeidbare Folgen der Wirtschaftskrise auf alle Teilnehmer hin. Gleichzeitig ist es möglich, die Krisenwurzeln in der Gesamtexpansion des Geldangebotes in verschiedenen Formen zu erkennen, die eine beschleunigte Erhöhung der Werte unterschiedlicher Vermögensformen beeinflusst hat. Im Zusammenhang mit Montenegro ist es auch möglich, die Theorie von Geschäftszyklen der österreichischen Schule anzuwenden und die Krisenursachen- und folgen zu erläutern. Die Bedrohung dem erreichten Globalisierungsniveau der Weltwirtschaft spiegelt sich in wiederholter Erscheinung von unterschiedlichen Protektionismusformen wieder.*

Schlüsselworte: *Krise, Geschäftszyklus, Globalisierung, Österreichische Schule*

Резюме: *Экономический кризис показывает высокий уровень глобализации мировой экономики. Хотя единый мировой рынок не доведен до конца, технологический подъем и экономическую взаимосвязанность, указывают на неминуемые последствия экономического кризиса на всех участниках. Наряду с этим, можно заметить корни кризиса в общей экспансии предложения денег в разных видах, которое повлияло на ускоренное увеличение стоимости разных видов имущества. В контексте Черногории, возможно, также, использовать теорию деловых циклов австрийской школы и объяснить причины и последствия кризиса. Угроза достигнутому уровню глобализации заключается в новом выявлении разных форм протекционизма.*

Ключевые слова: *кризис, деловой цикл, глобализация, австрийская школа*

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Introduction – Austrian theory of business cycle

According to many, current economic crisis is the deepest one since the times of the Great Depression. Its beginnings were marked by the collapse of the mortgage securities market. However, it was only the tip of an ice berg. Since then it has been an avalanche. Failure of many financial corporations, as well as the reaction of the then American administration (especially given their neoconservative ideological profile) was astonishing to many. Shaken financial order of the world economy inevitably spurred the economic crisis. Economic hurricane has reached the degree of 4 and 5, as it is obvious that it is no inventories glut which implies demand adjustment. The very demand in the world stumbles²⁴.

It is virtually on a daily basis that we record different and ever darker forecasts over economic growth. Recently the IMF has estimated the lowest growth – practical stagnation of the world economy in 2009 – since the late 40s. It would be no surprise if the assessment is revisited at some point suggesting the world economy shrink. As the crisis has advanced so has fear and uncertainty. At the beginning the single response to the crisis was to pump in additional liquidity by cutting reference interest rates and increasing consumption, without paying too much heed if any to the risk of a growing inflation afterwards. Evidently, it was motivated by the Friedman like explanation of the Great Depression²⁵. As it was concluded by Friedman and Schwarz, Fed was responsible for the Great Contraction by allowing dramatic reduction of the money supply when crisis broke out. Given such conclusion a straightforward response to the business cycle issue is injection of liquidity based on the Fischer theory of money. It is expected that the new cash would be in principle evenly distributed throughout the economy²⁶.

At the same time, in both scientific and more general public sphere, the debate on the cause of the ongoing crisis has been blazing. The question that has dominated the air is whether liberalism (or more precisely neoliberalism) that had led to the financial deregulation or the state is responsible for the treading economic crisis. To that end, one can already call upon some respectable research implying that the credit growth had been stoked by the Fed, while the other cause is the policy of

²⁴ Alan Greenspan, *The Age of Turbulence*, The Penguin Press, 2007, New York, page 67

²⁵ The FED was particularly active in taking that sort of the approach. Ben Bernanke, governor of the Fed, was studying long and in details the Depression, claiming he would not let credit contraction. Gerald P. O'Driscoll Jr. Added to *cato.org* on December 18, 2008. This article appeared in the [New York Post](#) on December 18, 2008

²⁶ Friedman uses helicopter analogy to explain the effect of new money claiming that the economic basis of a society does not change. However, Austrians contend there be a big difference dependant on the way money pours into the system as that affects structure of production and consumption in an economy. Mark Skousen, *Vienna & Chicago Friends or Foes?*, Regnery Publishing Inc, Washington, 2005 page 161-219

underpinning the problematic mortgage loans through various schemes of subsidies and guarantees. One can immediately associate with the role of the Congress in stimulating activities of the mortgage loans insurance agencies such as Fannie Mae and Freddy Mac, as it has been a prominent policy measure of all the US administrations in the past two decades²⁷.

The author of this paper holds that this may be an opportunity to use the thesis and conclusions deduced by the Austrian school of economics in the context of their theory of capital and interest in order to perform the analysis of the current economic crisis. The corner stone of the related theory was placed by Bohm Bawerk, who scrutinised the relationship between the values of present and future goods in correspondence to the time preference of consumption²⁸. From the Menger's principles of the consumer's preferences point of view, it is the present consumption that is preferred by consumers which makes obvious the difference in values between present and future goods. Put differently, interest is a consequence of a different preference. Reduction in interest increases the value of the future goods, while the increase in interest decreases the value of the future goods. The very tendency may be under influence of various factors, including the influence governments may decide to exercise. Additionally, according to Bohm Bawerk's interpretation, lower interest rate implies higher level of savings and the inclination towards future goods. Given that framework, entrepreneurs stand more ready to engage in more complex and longer production process and the other way around²⁹.

Based on such a laid out theory of capital and interest Mises develops his own theory of business cycle. The chief message is that credit expansion which does not stem out of the growth of savings harms economy. The reason is that the preference to save regulates time structure of consumption and production³⁰. World taken as a

²⁷ See for details Lawrence H. White, How Did We Get into This Financial Mess, Cato Institute Briefing Papers, November 2008 www.cato.org

²⁸ Bohm Bawerk first distincts lower order goods (immediate consumers goal) from higher order goods (capital goods – interphase goods). Also, he introduces subjective time preference for consumption which helps notice difference between present consumption (normally consumers prefer it) and future one. The theory points to the senselessness of the marxist thesis of the labour exploitation as it suggests different prospective. An entrepreneur engages capital and provides for workers wages even though his-her business venture has not been complete and does not generate income. Israel Kirzner, *The Meaning of Market Process*, Routledge, New York and London, 1992, page 61

²⁹ Jesus Huerta de Soto, *Money, Bank Credit and Economic Cycles*, Ludwig von Mises Institute, 2006, Auburn, page 266-305

³⁰ Mises based his business cycle theory on Bohm-Bawerk's theory of capital and interest and Wicksell's hypothesis of a „natural“ interest rate that reflects natural savings rate in an economy and is different from actual market rate, as well as on Hume-Ricardo presumption that rules out the possibility of a longer period of inflation under the system of gold standard. Mark Skousen, *Vienna &*

whole, it means that global savings should get equal to global investments. As economy is not a static category, the relationship becomes the issue of whether there is the equation between intended global savings and intended global investments. If intended investments surpass intended savings then it leads into the growth of the real interest rates which is supposed to foil intended investments consumption and vice versa³¹. Entrepreneurs make their decisions on the basis of their expectations, of what future should bring. In the end the outcome is compared to the preferred one, and entrepreneur realises whether the mistake has been made entering the venture, or the chance that had showed up has been grabbed. One should also take into account that a potential chance is nothing else but the consequence of other entrepreneurs' errors that had not reacted appropriately to the consumers preferences.

To that end, various means of money (cash, deposits, loans generated by friction reservations, securitised mortgage loans etc) had swollen the money supply and led the interest rate to the level below a „natural“ one. Market value of various sorts of assets was growing between 1985 and 2006 faster than the nominal GDP was which affected significant growth of the world liquidity³². Consequently, it moved time structure of consumption in favour of the production of goods more demanding to produce from the complexity and length point of view. Put differently, it stimulated production of higher order goods, the ones further from present consumption. The global impression grew that the intended savings surpass by far the intended investments which helped inflate the bubble. Inevitably, capital goods inflation takes place. As those goods are further from the present consumption, in those industries it is manifested also in high volatility of their prices, quantity of production and levels of employment. Dramatic change in perception and expectations helped financial structure collapse, as it lost its liquidity – it seemed as money simply evaporated. By pumping money into the system one tries to resolve the problem of liquidity, that is to maintain the same time structure of consumption though unsustainable – people reacted by adjusting their behaviour to the new set of information.

At the same time, when state makes decision on policy making one should take a note of the time gap that always exists, as government institutions by their nature lag behind³³. If policymakers knew the way people behave tomorrow in making their market decisions, it would probably be possible to pass economic policy decisions which lead to preferred outcome. However, something like that is not possible. For that reason, governments very often make things worse by not letting market forces

Chicago Friends or Foes? , Regnery Publishing Inc, Washington, 2005 page 168-169 i Ludwig von Mises, The Theory of Money and Credit, Liberty Fund, Indianapolis, page 377-404

³¹ Alan Greenspan, The Age of Turbulence, The Penguin Press, 2007, New York, page 385

³² Ibid page 14

³³ The economic calculation problem is a consequence of the fact that state cannot resolve the problem of unconsciousness of the lack of knowledge. Israel Kirzner, The Meaning of Market Process, Routledge, New York and London, 1992

act to retrieve the appropriate time structure of consumption. Actually, if anything but governments are supposed to alleviate that process of readjustment. Normally, it collides with the political cycle. On the other hand, the existence of many interest pressure groups (trade unions or employers' associations) slow down the process of readjustment as it reveals bad investment calls or business decisions, or it leads to the loss of employment. The deeper the economic crisis the bigger the potential social costs. Therefore the fiercer is the opposition to letting things settle on their own.

Economic crisis in Montenegro – the „Austrian“ angle

Austrian school theory of business cycle offers useful explanation for the analysis of the crisis in Montenegro. Undoubtedly, world financial and economic crisis underpins the negative trends. Lack of liquidity, fall in consumption and revealing of bad investment decisions it all spilled over to the Montenegrin economy in a similar way.

For the analysis' sake it is useful to take a look over the trends in the Montenegrin banking-monetary system in the past several years. Simple analysis of data collected by the central bank suggests dramatic increase of the money supply in the period preceding the crisis, as well as much too rapid credit expansion particularly in 2007.

First, the analysis of monetary data on various aggregates shows their growth by each of them:³⁴

	2003	2004	2005	2006	2007
M1	386,121	430,657	596,267	1,078,773	1,535,336
M11	402,586	437,114	614,721	1,098,530	1,556,994
M2	460,837	535,548	802,256	1,507,066	2,606,298
M21	494,290	546,525	867,294	1,586,654	2,728,244

In 000 euros

³⁴ Monetary aggregat M0 is made of banks deposits with the CBCG and assessed amount of cash flowing. Monetary aggregat M1 is made of M0, non banking sector sight deposits with banks and the CBCG in euros and other currencies excluding central governments deposits. Monetary aggregat M11 is made of M1 plus central governments sight deposits in euros and other currencies. Monetary aggregat M2 is made of M1 and time deposits of the nonbanking sector kept with the banks and the CBCG excluding central governments deposits. Monetary aggregat M21 is made of M11 plus time deposits of the nonbanking sector including central governments deposits in euros and other currencies. Central Bank of Montenegro Annual report 2007

As it can be seen from the presented figures, there was strong growth of the money supply by all the aggregates in 2006 and 2007. For example, the growth of the money supply by the end of 2007 to the year was 71, 9% if the broadest M21 is taken into account.

Similarly, the same conclusion can be drawn by the analysis of the growth of credits³⁵.

	2003	2004	2005	2006	2007
Total credits	200,6	281,5	375,9	847,2	2,246,6
Total deposits	211	273,2	487,9	1,075,8	2,091,1

In 000 000 euros

It is obvious that the growth of credits is linked to the growth of deposits. By saying that, one should bear in mind significant changes in the structure of deposits that took place between 2003 and 2007. While the relationship between businesses and population deposits was 91 to 45,1 million euros in 2003, in 2007 it was 663,5 to 1,019,3 million euros in favour of population deposits. At the same time, corporate loans, though converging to retail loans, is still stronger component in total loans structure. Back in 2003 it was 126,6 to 49,9 while in 2007 it was 1,364,4 to 795 million euros. It is worthwhile noticing that the vast majority of loans get covered by deposits. However, it is also worthwhile noticing that long term loans coverage with long term deposits stood at only 42% in 2007³⁶.

For the sake of analysis adjusted to this paper, it is necessary to figure out interest rates trends for specific sectors. The trend of interest rates reduction is evident in the period 2005-2007. Generally both average pondered nominal and effective interest rates took the falling tendency throughout the economy and various industries. As a consequence of the credit expansion in 2006 and 2007 the process quickened, albeit at different speed in some sectors³⁷.

³⁵ Ibid page 61

³⁶ Ibid. page 25

³⁷ Ibid page 66

	2005	2006	2007
Real estate trade APIR – effective	13,04	9,51	8,72
Construction APIR – effective	12,72	9,06	8,69
Services, tourism, APIR – effective	11,06	8,55	9,39
Transport, storage, APIR – effective	10,81	9,37	8,37

In % annual (end year data), APIR – average pondered interest rate

Between 2005-2007, interest rates fell sharply, and in virtually all the sectors of the economy. In particular, it is interesting to take note of a strong decline in the interest rate related to the sector of construction and housing. It obviously corresponds to the ever bigger amount of work in the related period. The drop in the interest rates implies that banks were stimulating this activity, too. Similarly, the same accounts for the production industries, while as a contrast after a sharp decline in the fields of tourism and services in the observed period there was a reverse trend in 2007. From the amount of loans point of view, the retail (population is still the net creditor) participated with 35,15% and it was followed by trade which held 26,1%. Construction and housing along with the sector of services and tourism were far ahead of other industries with 9,03% and 8,63% participation rate respectively. Areas of transport and storage business as well as real estate trade saw biggest rise at the end of 2007 with the participation rate of 3,55% and 3,56%, respectively.

How does it look from the Austrian school of economics business cycle theory point of view?

In the years preceding the crisis, the time structure of consumption appeared to have moved in favour of those goods which take more time and more complex phases of production. Though the trade sector dominates still, naturally, housing and construction industries and real estate trade directly linked to it mark strong and dynamic growth, as well as those other interrelated industries to the construction and trade such as transport and storage. Regardless of the fact that those investments were not all housing ones for instance, the consequences are the same. By a comparison, investments in the field of tourism (hotels, rent apartments and other) were based on the expected high level of consumption in the years of a loan repayment.

As illiquidity spills over to the Montenegrin economy one may expect gradual rise in the interest rates with shorter maturity of the net new loans especially in those sectors that take more time to produce goods for the present consumption. By a rule,

interest rates retreat to a higher level from where they were before the crisis. Wielding the Austrian terminology while explaining the roots of the crisis we may conclude that interest rates were at certain point lower than the wicksellian natural rate which stimulated investors into business ventures of producing goods that are longer and more complex ones. It is logical that the financial institutions will be less willing to approve new credit facilities the same way they did before the crisis. It is also rational to expect that the regulators – central banks, will conduct stricter policies as the aftermath of the reckless loan policies. Even if nothing changes in the supervision, the reason for the rising interest rates trend to exist is the failure of certain entrepreneurial enterprises. Combination of all of that will prolong the recession. In the framework of a small country it is only the inflow of the fresh capital, or foreign demand that may revert partially that trend but it cannot fully stop it as that inflow would not affect the trend of the interest rates readjustment.

The market economy trials

In times of the economic crisis the whole complexity of the social structure gets exposed to the light. Frommian escape from freedom towards security gets dominant. Various forms of economic nationalism, or protectionism tend to blossom.

It is enough to remember protectionist policies which influenced decrease in the level of the global trade back in 30ties and contributed to the depression contagion spread. One of the most éclatant examples is the Smoot-Hawley act dating back in 1930 which increased almost 900 tariff rates. The problem of the falling GDP linked to the issue of deflation could not help but further got deteriorated by the new wave of protectionism. The final consequence, of course, was the drop in the global trade³⁸.

Last time it happened was in 1982, and it is forecasted to repeat in 2009 when the overall drop in the global trade might be around 2%³⁹. Ironically enough, the fall in the global trade might be followed by the changes in the foreign trade policies of the WTO member states. Many countries had previously unilaterally reduced tariff barriers, and now it could take the reverse trend – all within the World Trade Organisation rules. Should all the countries decide to increase the tariff rates up to the level allowed by the rules it would result in the overall drop of the global trade by about 7,7%⁴⁰. It is clear what would be the impact over the global GDP.

³⁸ The Battle of Smoot-Hawley, The Economist December 20th 2008 page 115

³⁹ Barriers to Entry, The Economist December 20th 2008 page 113

⁴⁰ Assessed by Antoine Bouet and David Laborde from the International Institute for the Food Policies Research, Ibid page 113

Some economists start to talk of the deglobalisation phenomenon⁴¹. That process would be comprised of the global trade reduction, fall in financial flows, slower flow of labour force. While on the one hand exporting countries start to monitor the drop of their exports, it is expected that the capital inflow into the developing countries will drop from 1 thousand billion in 2007 to 530 billion dollars in 2009. Also, International Labour Organisation predicts annual growth of unemployment of about 30 million people compared to the level of 2007, which would thus affect the decline in migration flows⁴².

Nevertheless how convincing presented data are it is difficult to speak of deglobalisation. At least not in the long run. Economic policies of certain countries may be revisited in order to apply policy measures in attempt to reduce both import or export dependence, though. However, success of such policies would imply existence of the stationary economic system, as well as possibility to resolve economic calculation problem by a government. It is a characteristic of a democratic society that many interest groups tend to wield their influence in a public sphere. It is principal reason why calls to enjoy higher level of economic security get incarnated in different forms of the welfare state are so propulsive in parliamentary democracies. Additionally, it is a protective mechanism that acts preemptively from a radical expression of social unrest, or helps amortise it. On the other hand, regardless of often economically inefficient proposals one should bear in mind that the parliamentary system is a protective mechanism from radical turnarounds that deepen insecurity further – whether they come from the streets or as a governing structure output.

Of course, whether the mechanism proves effective or not depends upon how developed and legitimate democratic institutions are. It is necessary to recall that the economic crisis helped significantly national-socialists climb to the centre of power in Germany destroying fragile democratic institutions along their road. In Britain, however, the institutions remained untouched⁴³. For that reason, one has to keep prudent when reflecting on the calls to set up new versions of capitalism. Actually, the question is whether equilibrating forces – harmonisation of human needs on the global level and the further development of technology that contributes globalisation over the long haul – will prevail over disequilibrating forces associated with the closure of the national systems within. The author of this paper strongly believes that the former ones will prevail. Crisis can not be a permanent state of affair, rather an

⁴¹ Walden Bello Phillipine economist uses the term in his book *Deglobalisation, Ideas for a New World Economy, Turning Their Backs on the World*, *The Economist* February 21st 2009, page

⁴² *Ibid*, page 58

⁴³ See Ian Kershaw, *Hitler Hubris: 1889-1936*, Utopija, Beograd, 2003

incident, as the Austrian school of economic tradition confirms when equilibration forces are to be studied.

Concluding remarks

Though still marginalised, it seems that the Austrian tradition offers very clear explanation to the ongoing crisis. At the same time, the same school tradition sheds new light on what in today's world countries try to do to overcome the problem of the recession. Economic crisis suggests world economy has reached high level of being globalised. Though not yet a single world market, technological advancement and economy intertwined inevitably affects all the market participants. At the same time, it is possible to identify fast money supply expansion of different forms to be in the roots of the crisis leading to quick inflation of various asset prices. Therefore the collapse was inevitable, just like it was contended by Hayek and Mises in late 20ties. In the context of Montenegro one could scrutinise economic crises by applying findings of the Austrian school of economics theory of business cycle to it. The aftermath of the world crisis will undoubtedly impose a trial for the concept of the market economy. The threat to the achieved level of the globalised world economy is in reappearance of different forms of protectionism, but in the long term there is bigger likelihood the globalisation trends will continue. Connection between the markets and the appropriate harmonisation of human needs will reestablish that process given the expected further development of technology and the information diffusion.

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Small open economies and the global financial crisis

Abstract: World financial crisis has reached major proportions in early 2009. Countries respond to the crisis using similar models (state intervention, expansionary monetary policy, etc.). However, small open economies are more exposed to developments at the global markets. Also have limited tools at their disposal.

What measures small open economy can take? We analyze the case of Montenegro.

Key words: Small open economy; Financial Crisis, Fiscal policy

Resumee: World Finanzkrise hat größere Ausmaße Beginn des Jahres 2009 erreicht. Länder auf die Krise reagieren, die ähnliche Modelle (staatliche Intervention, eine expansive Geldpolitik, etc.) .. Allerdings sind kleine offene Volkswirtschaften mehr Veranstaltungen in den globalen Märkten ausgesetzt ist. Sie haben auch begrenzte Mittel zur Verfügung.

Welche Maßnahmen kleine offene Volkswirtschaft kann? Wir analysieren den Fall von Montenegro.

Stichwort: Kleine offene Volkswirtschaft, Finanzkrise, Finanzpolitik

Резюме: Мировой финансовый кризис докатился и до крупных размеров в начале 2009 года. Страны, ответившие на кризис с аналогичными моделями (государственного вмешательства, экспансионистской денежно-кредитной политики и т.д.) .. Тем не менее, небольшой открытой экономики в большей степени подвержены событий на мировом рынке. Кроме того, они имеют ограниченные в их распоряжении инструменты.

В какой степени для небольшой открытой экономики могут быть применены? Мы проанализируем случай Черногории.

Ключевые слова: небольшой открытой экономики, финансовый кризис, налогово-бюджетной политики

Introduction

Although the indicators pointed to the financial crisis that will take a global scale at the beginning of the XXI century, the volume and intensity have still outperformed expectations. The financial crisis became evident in most economies in the world in late 2008. The order took on a significant scale in early 2009.

Depending on the characteristics of the economic system, the size and strength of the economy, all countries are facing crisis applying similar methods (state intervention,

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expansionary monetary policy, etc.)... However, it seems that the most sensitive are small open transition economies, for several reasons:

1. After several years of stagnation in the development, recovery has finally become a real and visible. However, the financial crisis has stopped the process and still under-developed economies face the same problems that have highly developed economies with long-standing tendency of growth and significantly higher number of instruments available;
2. Rapid economic development of the small open transition economy, such as Montenegro, was based substantially on the inflow of foreign financial, fixed and human capital (FDI, portfolio investment, know-how). The beginning of the crisis marked stagnation or in some cases the withdrawal of foreign capital. Invested capital is not yet realized to the extent to strengthen the local economy, so that a significant number of projects are still under construction or implementation, making the current situation in these economies further difficult.
3. Given that economic development has been predominantly based on the international economic cooperation, any recession or a crisis at the international level directly affects the economy of a small open economy, with no possibility to prevent adverse effects in the form of substitution or rapid changes in the structure of economic activity. The only available model alleviate the crisis is great flexibility, which in terms of the global financial crisis can not be used due to potential reduction of investment and purchasing power.

What is impact of global financial crisis on the economy of Montenegro as a small open economy and which are instruments that can mitigate the negative effects of global recession, are fundamental issues that are discussed in this paper.

1. The global financial crisis of 2007-09

The financial crisis became evident in July 2007 at the financial market of the United States, more specifically at mortgage obligations market. While the most experts see the mortgage crisis as the beginning of the global financial crisis, the causes are older. In accordance with U.S. economist Dean Baker, who in 2002 pointed to a possible financial crisis, the crisis is the result of growth in real estate prices since 1995.

Crisis of commercial banks, which initially appeared in the U.S., and later received the outlines of the world scale, reflected in the economic and financial activities, with the following consequences:

- A decrease in lending activity of financial institutions to all users (companies and citizens);
- Recession in the capital market;
- Problem of liquidity of investment funds;
- Depreciation in values, above all, on financial assets, which creates a problem especially for insurance companies and pension funds during the upcoming payment obligations;
- The growth of public debt and total public spending, as a result of the intention of the state to mitigate the consequences of the global financial crisis;
- Depreciation of value of a number of national currency (Icelandic crown, some European currencies and the currencies of countries of South America), and the overall sensitivity and the unpredictable climate.

First symptoms of the global crisis were reported in most countries in late 2008 while in 2009 become even more visible and stronger.

2. Economic policies in response to the global financial crisis

The consequences of the global financial crisis, which began to feel in 2008, introduced doubts about the efficiency of the free market, its performance and stability. It was the signal for the revival of state intervention, and strengthening the active role of the state of the economy. Keynes theory postulates again became attractive, and policies towards the expansion of government spending, business subsidies, monetary financing of debt, are conducted in most of the economies in the world.

Are these measures necessary or not, and will have a positive impact on economic growth in the medium term? To answer this question, we must recall the following:

1. **Expansionary government spending must be financed.** There are two sources: increasing taxes or borrowing.

In the area of taxation, any increase in tax rates will further hinder business in an already difficult economic condition. In addition, reduction of business activity that is present in all economies will reduce the tax base so that tax revenue as a basis for expansion of fiscal spending won't have positive, but negative impact. On the basis of tax revenue, it is unrealistic to expect a rise in government spending.

It remains another source of funding - borrowing. However, if the state borrows money in the domestic financial markets, it will reduce the potential

for investment, which are already scarce in the period of crisis. In this way, additionally discourage the economic activity.

Government borrowing on the international financial market remains the only realistic option, but here we must bear in mind that it comes only to postpone the fiscal obligations to the country, which economic agents certainly have to pay, not today, but in the future.

If this measure of fiscal policy address current problems in the economy, will certainly make it difficult for business activities in the future, which will negatively affect economic growth in the medium and long term.

2. **Subsidizing business activities - providing support to businesses.** This measure, in part of financing of implementation, has the same negative effects on the economy as the expansionary fiscal spending. However, the survival of the company will result in preservation of tax base and maintain the purchasing power of the population growth through reduction of unemployment.
3. **Monetary financing of fiscal expenditures and maintenance of liquidity.** During the reduction of financial liquidity, increase debt and lack of investment capital, the monetary policy transmission function becomes actual. Increasing the supply of money affects the reduction of problems of insolvency, the reduction in interest rates and stabilizing the financial system. However, we have to be careful with monetary stabilization policy in order to prevent it from becoming «inflationary monetary policy»; which is certainly not a positive signal to any future contribution to economic growth.

3. The conditions in which Montenegro faces financial crisis

Features of the economic system and structure of economic activities in Montenegro determine methods that can respond to the effects of the global financial crisis, and the possible effects of economic recession. The most important are two features:

1. Montenegro does not have its own currency, and therefore has limited monetary policy instruments;
2. The economy is open and significantly import dependent.

3.1. The monetary system in Montenegro

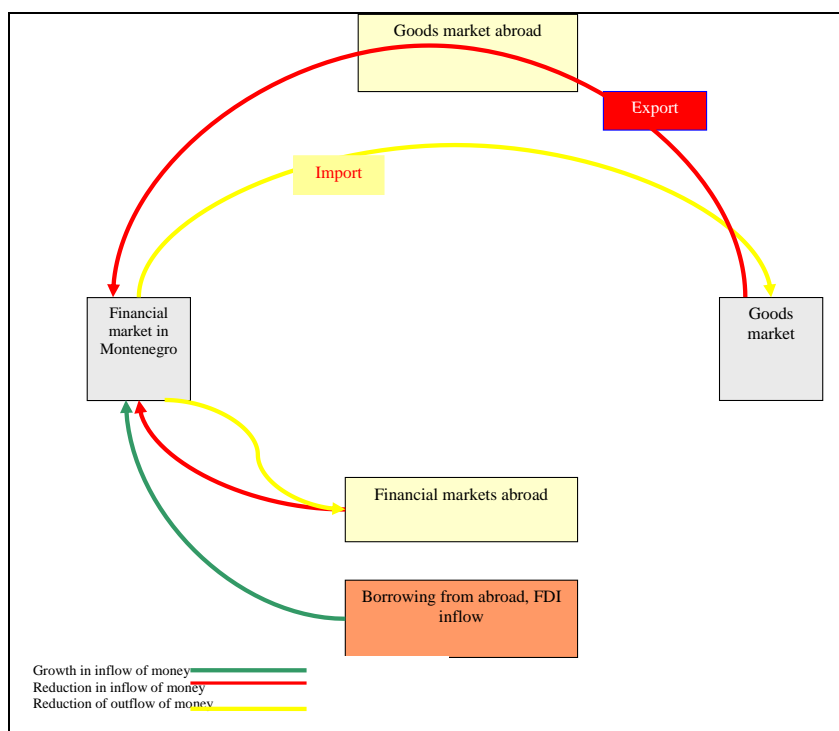
Introducing a Deutsche Mark (DM) in 1999 and later a EURO (€), Montenegro gave up monetary sovereignty. The motives of the establishment of such monetary regime

were primarily in the direction of creating and maintaining monetary stability in the long run. As a result, the use of instruments of monetary policy is reduced to a minimum⁴⁵.

Under this regime, the supply of money is entirely a function of international economic relations, i.e. balance of payments. The inflow of money from abroad, by all criteria (current and financial transaction) affects the increase, while outflow influence decrease of money supply, and then the interest rate that is formed on the money market.

Any changes in the financial markets are solely the result of market forces (supply and demand for money), without impact from monetary or other authority⁴⁶. The influence of movement on other markets to the financial market in Montenegro is shown in the following graphic.

Chart 1: Financial Flows in Montenegro



⁴⁵ Monetary authorities in Montenegro can only use reserve ratio as instrument of monetary policy.

⁴⁶ Principles of high level of economic freedom are implemented in overall institutional system in Montenegro (goods market, capital and money markets, real estates markets and labor market). This means low custom tariffs, domestic status of foreigners, high mobility of labor and possibility to sell land to foreign owners.

Deficit financing in international financial markets is automatically transferred to the deficit in the financial markets of Montenegro, and vice versa. The same goes for interest rates. Reduced credit and investment activity in overseas financial markets affects the reduced inflow of funds in the financial market of Montenegro.

As a result of reduced purchasing power of the population, imports decline, with positive effect on the financial system. However, at the same time decreasing exports (reducing the tourist trade, the fall in the price of aluminum, etc.), has also adversely affects the financial system. However, in early 2009 there was a greater decline in imports than exports, which is observed in the short term as positive signal to financial markets, although realistically reflects the reduction in living standards.

3.2. The structure of economic activities in Montenegro

Montenegrin economy is characterized by three key characteristics: the dominance of services, the high concentration of export products and high import dependence.

The structure of GDP. In total value of gross domestic product⁴⁷, value added produced in the service sector makes 59.4%⁴⁸. Industry (including manufacturing industry) makes 11.0% of GDP, agriculture 6.6% and construction 3.4%⁴⁹.

Most of economic activities are import/export-dependent, in part of raw materials and markets:

- Due to the low level of domestic production, the subject of wholesale and retail are the dominantly imported products;
- Tourism (hotels, restaurants, transport and related activities) mainly rely on foreign markets, with the participation of foreign tourists of 86.82%. In addition, income from export of services makes 54,5% of the total export income of Montenegro, which is directly reflected in the money supply;
- Real estate services achieved the expansion in the period from 2006 to 2008, due to a large number of foreign investors that have invested in land and buildings;

⁴⁷ Data for 2007

⁴⁸ Services are: trade – 23.1%, real estates activities – 20.8%, Transportation – 18.4%, Hotels and restaurants – 5.6% and other services – 32.1%.

⁴⁹ Remaining 18.5% of GDP goes to taxes on products less subsidies.

- Construction is based on raw materials which are predominantly imported, with significant import of personnel due to the deficit in the domestic labor market;
- In the sector of industry, production of aluminum material as the most important export products of Montenegro is determined by situation in the international market. In addition, exports of aluminum makes 37.87% of total exports of products, or about 18% of total exports of Montenegro, which makes this branch not only important for real but monetary sector also;
- Manufacturing, which accounts for 6.9% of GDP mainly rely on domestic resources.

Based on the foregoing, we conclude that the situation in the economies with which Montenegro is making economic relations transfer to the local economy quickly and directly. Recession or expansion in the international sphere pulls the same direction of economic developments in Montenegro.

4. The consequences of the global financial crisis in Montenegro

The impacts of the global financial crisis have emerged in mid 2008, with decline of stock indices and turnover on the Montenegrin stock exchanges. In other markets, the effect of the crisis became apparent in late 2008 and obvious in 2009.

The disturbances took place in three key markets:

1. Money market;
2. Capital market;
3. The real estate market.

On the money market financial crisis reflect on⁵⁰:

1. The fall in amounts of cash to 9.7%;
2. M_1 aggregate⁵¹ depreciation of 18.8%;
3. Depreciation of the monetary aggregate M_2 to 12.9%⁵²;
4. Fall of loans in the second half of 2008;
5. The fall in total deposits of 4.6%;
6. The growth of the average effective lending interest rates by 0.25 percentage points⁵³;

⁵⁰ Value in December compared to January 2008 – for all variables

⁵¹ Cash and Demand deposits, including government deposits

⁵² M_1 plus term deposits, including government

⁵³ Average: loans to business sector and citizens, with different maturity

7. Growth in average effective borrowing interest rate for 1.00 percentage points⁵⁴.

The money market indicators were presented in Table 1.

Table 1. Money market in Montenegro in 2008.

	M0 - cash - million €	M1-cash and demand deposits - million €	M2-cash, demand deposits and term deposits - million €	Total loans - million €	Total deposits - million €	Deposits by citizens - million €	Weighted average effective lending interest rates	Weighted average effective borrowing interest rates
Jan-08	568.0	1,489.6	2,686.3	2,268.0	2,045.8	1,042.4	9.15	3.21
Feb-08	572.7	1,499.2	2,774.9	2,393.6	2,138.9	1,058.8	9.15	3.55
Mar-08	544.8	1,461.5	2,755.5	2,467.8	2,140.1	1,061.0	9.16	3.65
Apr-08	557.5	1,473.4	2,826.6	2,586.9	2,200.1	1,089.3	9.15	3.74
May-08	562.6	1,494.4	2,867.6	2,654.5	2,229.6	1,083.0	9.18	3.71
Jun-08	558.4	1,489.5	2,920.0	2,719.5	2,275.2	1,075.4	9.23	3.73
Jul-08	568.6	1,463.0	2,951.3	2,794.4	2,280.7	1,110.9	9.24	3.92
Aug-08	580.6	1,496.2	3,041.8	2,826.9	2,346.0	1,123.1	9.29	3.86
Sep-08	566.7	1,450.3	2,968.0	2,852.3	2,325.9	1,114.1	9.31	3.97
Oct-08	508.5	1,299.4	2,682.0	2,813.6	2,168.1	982.2	9.30	4.15
Nov-08	506.0	1,243.7	2,544.3	2,779.9	2,068.6	898.0	9.30	4.28
Dec-08	512.4	1,208.5	2,338.5	2,769.0	1,950.9	834.9	9.40	4.21

Source: Central bank of Montenegro

The values of most of these variables, according to unofficial estimates⁵⁵, recorded negative trends in 2009 - the reduction of credit activities, value of monetary aggregates and interest rates. Due to the short-term bonds issued by the Ministry of Finance, and the ability of commercial banks to buy part of the records of funds from the reserve, the amount of deposits increased in the first half of March 2009 to 47 million €.

At the capital market, the global financial crisis reflected through:

1. The fall in turnover on stock exchanges by 63%;
2. Depreciation of stock index: MOSTE to 69%, NEX 20 - 69% and NEX PIF - 83.5%;
3. The fall of the value of market capitalization by 52% by the end of 2008.

The capital market indicators were shown in Table 2.

⁵⁴ Average: interest rates paid on term deposits of citizens and business, with different maturity

⁵⁵ Official statistics is not still available

Table 2. Capital market in Montenegro from jan 2008 – feb 2009

	Stock market turnover - €	MOSTE	NEX 20	NEX PIF	Market capitalization (mil €)
Jan-08	16,782,935	1,450.4	30,626.2	33,880.9	4.697
Feb-08	20,828,518	1,446.5	30,273.2	33,839.7	4.370
Mar-08	19,267,076	1,215.3	24,958.9	27,686.0	4.170
Apr-08	20,508,993	1,051.0	23,195.1	25,198.3	3.927
May-08	8,766,949	928.0	21,359.8	21,730.9	3.603
Jun-08	15,666,154	769.2	18,077.8	17,736.1	3.232
Jul-08	14,232,115	783.8	19,387.9	17,720.9	3.256
Aug-08	24,205,901	710.9	17,361.3	15,953.6	3.233
Sep-08	9,608,878	634.7	15,309.4	13,193.8	3.032
Oct-08	7,577,936	455.2	11,096.0	7,898.8	2.594
Nov-08	9,723,238	373.1	8,378.8	5,305.3	2.382
Dec-08	5,704,903	469.5	10,002.9	5,844.6	2.237
Jan-09	3,438,808	529.7	10,850.3	7,337.7	
Feb-09	6,108,316	446.9	9,452.0	5,560.3	

Source: Montenegroberza, NEX Montenegro, Securities Commission of Montenegro

At the **real estate market** decline in turnover is evident, almost close to zero, and gradually comes to falling real estate prices.

In other markets, the effects are yet to appear as follows:

1. The market for finished products - drop in imports and trade of final products, especially from the category of luxury goods (cars, clothes, etc.). In January 2009, decrease of exports of goods by 3.68% and imports by 25.4% compared to the same period last year was recorded.
2. The market of production factors - the fall in employment and real wages. In February 2009 the real wages decreased by 0.6%, while unemployment decreased by 0.96% in the first quarter of 2009 compared to December 2008.
5. **What are options for economy of Montenegro, or how it may react to the impact of the global financial crisis?**

The key problems that the economy of Montenegro is facing in terms of the financial crisis are:

1. Reduction of inflow of funds, which entails:
 - a. Reduction of credit activities of commercial banks and interest rates;
 - b. Problems of maintaining liquidity in the money market;

- c. Recession on the capital market and reduction in market capitalization.
2. Decrease in exports due to reduced demand (consequence of economic recession).

Reduction of the inflow of funds and reduced credit activity of commercial banks hinders the implementation of already initiated and planned investment projects. This should be added to the liquidity problem of economic agents, i.e. increasingly frequent requests for reprogramming of existing credit obligations, which are a consequence of the expected decrease in income and falling demand. In addition, the recession in the capital market has made credit lines that were related to the movement of prices of securities problematic. The situation is similar to those that are related to the property market. Generally, the problem of returning the loans are going to intensify even it has not attained the critical zone yet.

Expected GDP growth in 2009 was reduced from optimistic 7% at the end of last year to 2% after the third quarter of 2009. Reduction in the volume of economic activity is reflected in the sector of construction and trade, while in the field of manufacturing and mining and quarrying reduction is in part related to the aluminum industry. These sectors are key sectors seekers rescheduling of loans and sources of bad loans.

Side effect is a reduction in imports, which is a positive signal in short term for the current liquidity problem, but actually is a sign of reduction in production activity and falling living standards.

What is the model for Montenegrin economy to react to emerging problems under conditions where no possibilities of using the instruments of monetary policy exist are?

First, the most important goal that is set is to maintain financial system liquidity. In this regard, given that it is not expected to increase exports, the only instrument is a borrowing in international financial markets and the inflow of foreign capital. Given that most commercial banks in Montenegro are foreign-owned, it is possible to get more capital or investment from the parent banks, which are already in a certain extent and implemented. In addition, the foreign public debt of Montenegro is at a low level, which allows the borrowing abroad.

Related to foreign investment, in 2009 is expected that the largest privatization project in Montenegro will be completed - Montenegro Electricity power plant, which will be recapitalized, with the possibility of investor to acquire majority stake in the future. Implementation of this project would provide capital inflows in the amount of approximately 20% of GDP of Montenegro, which would be a flow of

funds sufficient to maintain the stability of the financial system. In addition, another major investment projects in the sphere of tourism and infrastructure were announced, but we must take into account the risk of realization of investment due to current situation in overall markets.

In the sphere of macroeconomic policy, Montenegro virtually has only instrument of fiscal policy, which generally go in two directions: changing the tax system and / or adjustments in fiscal spending.

However, when defining the fiscal policy measures we have to consider the fact that fiscal revenues in the period of reduced economic activity may be reduced, so that the state budget alone will have the problem of liquidity. However, below we present our opinion on possibilities and effects of using fiscal policy measures.

1. **Tax rates.** Reducing tax rates is a trend that is present in Montenegro over the past few years. Tax rates on income of physical persons and legal entities are among the lowest in the region (15% and 9%), a value added tax too - 17%. In addition, a number of tax rates are competitive or equal to 0% (e.g., capital gains tax for citizens). With reduced economic activity and thus reduced the amount of taxes collected, which was accompanied by increased demand for financing a series of measures of economic and social policy of the state, is it reasonable to reduce tax rates further? It is possible, but it is unrealistic to expect.
2. **Subsidizing the economy** - government intervention in the economy. Support companies in the era of the financial crisis are a model that was applied in many countries in the world. However, in the case of Montenegro, it is questionable to fund support for companies, as well as to select branches and enterprises which is economically rational to be supported. In the previous period, support is provided to the financial sector, through short-term loans for liquidity. Financial support was expected by companies in other sectors (KAP, the tourism industry ...). However, rehabilitation of the companies at the expense of growing budget deficit, government borrowing and delay capital projects, will not yield positive results in the medium term. In the short term, it will make slower the decline of living standards, reduction of employment and preservation of the tax base. But is the price to high?
3. **Investment activities of the state.** In the previous structure of the budget expenditures in Montenegro, expenditures for current consumption dominate. Expenditures for capital investments are extremely low. Is it, under the reduced investment in Montenegro, possible to reduce the recession initiating capital investment by the state? Possibly, if they provide funding. It is unrealistic to expect to finance capital investment from current revenues,

given that, due to reasons already mentioned, it is expected that government will maintain the budget deficit in the current year. Go for new loans from abroad? That is possible but with limitation coming from shortage in loans supply worldwide.

Our analysis resulted in conclusion that, under financial and economic recession, it is likely unrealistic to expect big turns in fiscal policy in Montenegro. We will consider it successful if: government budget is liquid, budget deficit as low as possible and capital funds not transferred to current expenditures.

Conclusion

Uncertainty is the key word that marks the business and economic activities in the era of the global financial crisis. All economies (small, large, open, less open) are faced with problems of instability in financial markets, recession or reducing the scope of business activities.

In order to overcome the problem, depending on the availability of instruments, economies use a set of measures in the areas of monetary and fiscal policy. In addition, small economies have the possibility of faster and more flexible responses to problems, and also small-scale measures makes positive effects much higher than in the case of large economic systems.

Based on the example of Montenegro, we see that a small open economy can not solve the problems resulting from the crisis without a strong interaction with the international market. The involvement of local resources is limited. However, objective approach to their own abilities, positive rating in international markets and rational behavior of all economic agents contribute to overcoming the crisis with the least possible cost and maintaining existing capital in Montenegro.

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GLOBAL CRISIS AND FINANCIAL MARKET REGULATION

Abstract: *The largest debates today occur on the issue of the world's financial markets, i.e. turmoil initiated by problems of mortgage loans in the U.S. Bankruptcy of several largest investment banks and insurance companies, as well as huge losses in the financial sector, have launched numerous requests for state intervention and new regulations. The main aim of this paper is to try, from the standpoint of legislative policy and retrospective point of view, to assess the effectiveness and relevance of efforts for global harmonization of financial market regulation*

Key words: *regulations, harmonization, competition.*

Abstract: *Eine der Fragen, über die heute die größte Debatte in der Welt führt, ist der Finanzmarkt, beziehungsweise das Chaos, das durch die Probleme der Hypothekendarlehen in den USA gestartet wurde. Die Pleite einiger der größten Investment-Banken und Versicherungshäuser sowie große Verluste in der Finanzbranche wurden zahlreiche Ansprüche auf die staatliche Intervention sowie auf die neue Regulierung gestellt. Das Hauptziel dieser Arbeit ist es, zu versuchen, aus der Sicht der Gesetzgebungspolitik und aus retrospektiver Sicht die Wirksamkeit und die Relevanz der Bemühungen einzuschätzen, um die globale Harmonisierung der Regulierung des Finanzmarktes durchzuführen.*

Schlagwörter: *Regulierung, Harmonisierung, Konkurrenz.*

Резюме: *Одним из вопросов, вокруг которых ведутся сегодня самые большие дебаты в мире, является финансовый рынок, то есть, мятеж, который был инициирован проблемами ипотечных займов в США. Банкротство нескольких из крупнейших инвестиционных банков и страховых компаний, а также и огромные потери в финансовом секторе, дали толчок многочисленным просьбам о предоставлении государственного вмешательства и новых правил. Основная цель данной работы заключается в попытке, с точки зрения законодательной политики и ретроспективной точки зрения, оценить эффективность и значимость усилий по обеспечению глобальной гармонизации регулирования финансового рынка.*

Ключевые слова: *регулирование, гармонизация, конкуренция.*

Global crisis of financial markets

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The largest debates today occur on the issue of the world's financial markets, i.e. turmoil initiated by problems of mortgage loans in the U.S. Bankruptcy of several greatest banks and insurance companies, as well as huge losses within financial sector, initiated numerous requests for state intervention and financial aid, as well as new regulation.

The public has already been shown several researches and analyses, indicating that, without rapid technological advances, the main cause of the recent financial crisis in the USA are rules on capital adequacy of banks and activities (earning interests) caused by such rules.

Basel's standards emerged as an intention of „the club“ of European and American central banks in order to limit expansion of Japanese banks in the USA and Europe. In order to limit their expansion, the standards were established, justified by the fact that they are intended to provide „health “and „stability “of banks which are internationally active.

Global regulation of capital adequacy of banks defined by the Bank for International Settlement (BIS) requires that all international banks hold their equity capital at the level of minimum 8 % of their total assets value. This regulation emerged and started functioning in July of 1988, with the ambition to improve „health and strength“ of internationally active banks. This regulation is still in use, now in updated pattern called “Basel II”, published in July, 2004.

Regulation of capital adequacy of banks practically limits profit of banks, by limitation of value of their assets to only 12, 5 times, compared with equity capital. In order to answer to regulatory request, banks were forced either to reduce loans granting or to increase equity capital.

However, the life cannot be prescribed. Banks in the USA quickly responded to this regulatory challenge, formally fulfilling the request by reduction of their assets through “securitization”, i.e. by selling their receivables in the form of securities.

This financial technology quickly spread worldwide, especially in countries with huge and strong capital markets.

In countries where capital markets are not deep and in which „securitized“ loans are hard to sell, like in Asia, banks could not apply this new financial technology and were forced to reduce both their loans and profits.

In this way, international regulation of capital adequacy of banks, justified by the wish to establish equal conditions for all, actually created competitive inequality due to differently structured financial systems in different states.

The greatest failure of BIS regulation is that it solely regulates capital of banks in the world of borderless financial market.

How financial markets responded

Naturally, financial market responded with avoiding of this regulation not only in the form of securitization, but with creation and approval of loans to specific investment companies, as well as by investing into funds that are not subject to regulation.

When banks sell their „securitized“ loans, then they should find buyers who can hold those loans until their maturity date. Naturally, those buyers need money and therefore banks often gave them loans or even created its own special investment companies and funds which bought securitized loans.

However, special investment companies are independent subjects and were not involved in consolidated home banks' balance.

There are no obvious and clear standards for consolidation of special investment companies. When consolidation standards are discrete, how to expect regulation of capital adequacy of banks to be efficient?

Re-regulation requests grow

Recent events, crisis and failure of well-known banks and institutions have been followed by requests for governments and central banks to be involved in the rescue of financial institutions by injecting capital into banks and providing different instruments for liquidity.

Likewise, the need for re-regulation rises, i.e. the need to limit innovation and free business operations in financial market. All advantages arose in the past thirty years due to financial innovations; deregulation and freedom to innovate have already been forgotten.

Surely, similar request will soon appear in our market.

However, all financial innovations cannot lead to profit and income. Some financial innovations will surely appear both wrong and failures. But, due to that freedom of innovation cannot be limited.

Regulation is most frequently adopted solely after something happens.

Successful innovation in financial market are difficult to predict, so development of infrastructure that will help in implementation of successful innovations must go after those innovations. Existence of those failures and losses in financial world does not, in any way, lead to the conclusion that re-regulation will successfully prevent future failures.

Regulator – state, government body or agency – is capable to regulate organizational forms, but is not capable to regulate services which only just emerge or will emerge in the future. Informational and communication technologies will affect change of financial services and the fact who and in which manner offers financial services. New technologies and new approach to service offering make impossible the limitation of financial innovations by regulation.

It is maybe possible to regulate organizational form of service offering, but it is not possible to regulate functions. Can life be „caught“ by the rules? Can interests be prescribed?

Impact of globalization to capital market regulation

Capital market internationalization surely increases challenges for market regulators. Although the nature of market is in large part changed due to globalization, it is not followed by appropriate changes of the manner in which certain markets are regulated. Market internationalization inevitably causes regulatory competition, which tries to attract both investors and issuers.

Due to different structures of financial markets worldwide, regulatory measures which are intended to achieve the greatest possible level of market competence, differ from one market to another. Highly regulated markets are faced with the problem of preserving efficiency, i.e. the need for prevention of business transferring elsewhere, while less regulated markets are faced with the problem of attracting investors, trying to determine a framework of modern and functional market. Those problems also dictate enforcement of certain regulatory measures.

Recent legal amendments all over the world which, *inter alia*, have been caused by market internationalization, we can notice two tendencies: a) deregulation of legislation followed by competition of regulatory solutions in the aim of creation of

competitive market, and b) striving for harmonization of legislation by determining minimum standards and recognition of foreign countries' rights.

Intention to maintain competitiveness of the national market is opposed to intention of establishing harmonized legislation. Although at the first moment seems easy, orientation towards deregulation or harmonization depends on existence of many different conditions.

Relation between globalization and intention to create a competitive market

When it comes to harmonization of new legislative solutions in this area, it is necessary to point out that a number of authors emphasize that it is actually impossible to achieve it, at least not in the near future. Namely, on their opinion, differences among national systems, based on different historical experiences, brought to different regulation "cultures". Besides, impossibility of harmonization in this area is also caused by nonexistence of one regulator in a large number of countries, velocity of creation of new products in the market and different nature of participants in different markets.⁵⁶ Therefore, it is emphasized that higher level of harmonization can be solely achieved by further deregulation. However, deregulation can, as a consequence, have so-called "*race to the bottom*", i.e. deregulation and aspiration for liberalization can, as a consequence, have creation of suboptimal regulation. It is certainly necessary to establish minimum standards as common ones, although wide defining of those minimum standards, a manner of their implementation and desirable level of deregulation are differently understood and defined.

The need for deregulation is not a new one, but still causes various theoretical approaches. One cannot talk about deregulation and take a stand on it, unless regulation is broadly understood. It is usual that deregulation is considered as removing of barriers and also two types of deregulation are in place: *deregulation of conditions for access to market* (access deregulation) and *deregulation of protection from market abuse* (prudential deregulation).

Deregulation of conditions for access to market means reduction or removal of regulatory limitations and modification of regulatory structures in a manner to facilitate attendance of foreign participants in domestic market. Deregulation of protection from abuses means removal of unnecessary rules which are created to protect market from abuses, because a number of those rules does not have any or

56 See: Roquette, Andreas, New Developments Relating to Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community and Germany, University of Pennsylvania Journal of International Business Law, winter 1994, p.565.

have completely opposite effect.⁵⁷ At the same time, it is important to emphasize that deregulation does not represent bare reduction of regulatory limitations, but comprehensive ideology representing reducing the role of the state in the market.⁵⁸ Only after such reducing of the role of the state in the market, competitive markets can be created. Anyway, as the most competitive once can be the markets which are characterized by the lowest level of state intervention, the greatest liquidity, the lowest transactional costs, the greatest innovation freedom, as well as by the lowest tax obligations of market participants.

Need for reducing of the role of the state in the market cannot be brought in question, but the scope in which deregulation will be made largely depends on the level in which regulatory barriers were removed in competitive markets.

And here comes the main assertion - regulators must never passively respond to globalization and other regulatory competition. It is often emphasized that large number of regulators adopt globalization as a strategy only when it is the only one way left to avoid irrelevance.⁵⁹ Globalization and competition due to deregulation, actually force regulators to cooperate mutually and synchronize their legislative solutions in order to avoid marginalization.

When regulators are faced with the possibility of business to transfer elsewhere, unless this process can be stopped in some other way, they are forced to cooperate with other regulators and vote for harmonization of legislative solutions. Therefore, regulatory globalization emerges as a substitute for complete irrelevance.⁶⁰ As Macey stated, flexibility of demand for regulatory services of companies the rules are related to, is a function of the available alternatives⁶¹, i.e. if there is no available alternative regulatory regime, demand for regulation in a certain state will be extremely high. He cites an example of Italian capital market regulator (CONSOB), which, considering that Italian capital market is weaker than American, English or German, is forced to advocate for regulatory globalization.⁶²

On the other hand, a possibility to transfer business elsewhere, affects regulator in a manner that exit mechanism serves as a signal to regulator to advocate for the revision of existing rules. If they did not dispose with information submitted to it by the participants who use exit mechanism, regulators would, most probably, be ready

57 See: Warren III, Manning Gilbert, *Global Harmonization Of Securities Laws: The Achievements Of The European Communities*, Harvard International Law Journal, Winter, 1990, p.188-189.

58 See: Schwartz, Joseph M., *Democracy Against The Free Market: The Enron Crisis And The Politics Of Global Deregulation*, Connecticut Law Review, Spring, 2003, p.1097.

59 See: Macey, Jonathan R, *Regulatory Globalization as a Response to Regulatory Competition*, Emory Law Journal, Summer 2003, p.1359.

60 Ibid.

61 Ibid, sp.1362.

62 Ibid.

to create rules, by which they would enhance their powers, not market efficiency. That is why it is often emphasized that there is no way to measure how large is the influence of competition to limitation of excessive regulation.⁶³

Similarly, political, social and all other circumstances specific for national regulator and the market it regulates, affect nonexistence of aspiration for harmonization of legislative solutions and involvement into process of so-called regulatory globalization. And there is again flexibility of wrong demand for regulation. Events that increase the need for existence of national regulation reduce the need for existence of global legislative solutions. Macey also states that, when crises and catastrophe emerge it is considered that regulation is needed to bring the society back to its former, arranged status.⁶⁴ That is why it is not often perceived that although national economies relentlessly move towards globalization and financial integration, the same is not valid for regulation affected by political powers, more complex and less predictable than economic power.⁶⁵

Regulatory competition and non-acceptance of harmonization of legislative solutions, which inevitably assume compromise, happen to be strengthened and due to so-called regulatory imperialism, i.e. effort of regulators to unilaterally implant its legislative solutions into other states' legislative system and by doing so, to increase its power by persuasion and forcing of other states to establish rules preferred by that regulator.⁶⁶ The best, almost paradigmatic, example is effort of American Commission to widen territorial implementation of its rules on insider trading and to make them binding in all markets in which American shares are traded.

Regardless of the reasons that cause competition, regulatory competition has numerous advantages and disadvantages. Advantages of existence of regulatory regimes' competition are the following:⁶⁷

- **Existence of national regimes variety**, regulation is made in accordance with objectives of national economy;
- **Simplification of procedures**, as competition points to the need of ex ante compliance of rules;
- **Reduction of possibility of regulation failures**, as regulatory competition leads towards reduction of possibility for regulation to be an expression of political compromise;

63 See: Choi, Stephen J. – Guzman, Andrew T., National Laws, International Money; Regulation in a Global Capital Market, Fordham Law Review, No.65/1997, p.1890-1891.

64 See: Macey, Johnatan R., Regulation and Disaster: Some observation in the Context of Systematic Risk, u Brookings-Wharton papers on Financial Services, 1998, p. 405; quoted by Macey, Jonathan R, Regulatory Globalization as a Response to Regulatory Competition, p.1364-1365.

65 See: Macey, Jonathan R, Regulatory Globalization as a Response to Regulatory Competition, p.1365.

66 Ibid.

67 See: Woolcock, Stephen, Ibid, p.298 et seq.

- **Possibility of experimenting**, competition enables experimenting, flexibility and innovative regulatory policies:
- **Preserving sovereignty**, which enables national regulators to maintain control over a large number of issues.

Competition of regulatory strategies, or, broadly observed, regulators, also has numerous disadvantages. Regulatory competition, as a respond to greater globalization, causes the following problems:⁶⁸

- **Externalities problem**, competition of the rules, cannot solve, for example, the problem of transfer of systemic risk from one country to another. As there is a very large economic interdependence of the markets, problems in one market may lead with itself also problems in another market.
- **Large expenses problem**: considering that regulators have possibility to experiment and create flexible rules, they may be encouraged to use this possibility more often. Such frequent changes of legislation policy can, not only cause additional business expenses, but destroy business in whose interest is establishment of clear and stable rules. Also flexibility often allows regulators to create regulation which satisfies current political interests, that is not available in situations when regulation represents the result of consensus of national policies and interests;
- **Excessive regulation problem**, regulator may approach to regulation of certain issue also under pressure of existence of regulation of the same kind in other states. Problem is of particular importance when such pressure comes from strong states which try to impose their unilateral legislation policies and to persuade smaller states to follow them.
- **Oligopolistic competition problem**, having in mind limited number of strong national regulators, we may assume that "collusion" of national regulators will have as a consequence mutual effort to limit competition and desire to avoid competition with other regulators.

However, in order to achieve all positive effects that can be achieved by rules of competition, and primarily, convergence of existing legislative solutions, transparency and consistent application of rules are necessary. Without transparency, regulators cannot compare their legislative solutions with other regulators' solutions, and nonexistence of mechanism of efficient and consistent enforcement of those rules have as a consequence a nonexistence of confidence into real nature of legal solutions.⁶⁹

⁶⁸ See: Woolcock, Stephen, Ibid, p.300.

⁶⁹ Ibid.

Only then, both regulators and those the regulation refers to are able to go towards harmonization by comparison of existing legislative solutions.

Harmonization of legislative solutions and the role of regulator

Current regulatory competition and different regulatory policies certainly weakens the role of regulator. Faced with a challenge of losing importance of national market regulation, regulators are being forced to vote for harmonization of legislative solutions. When they decide to initiate harmonization of regulation, regulators may opt for one of the two possible approaches: reciprocity principle or principle of determining mutual standards.

Reciprocity principle assumes that regulator recognizes other states' standards (for example, that the prospectus for public offering, made in accordance with rules of one state, is recognized in the course of issuance of shares in another state. This approach to harmonization is usually adopted by those countries, which are mutually related by strong economic relations, and in which certain minimum standards are met. On the other hand, principle of establishment of mutual standards means change of existing rules or its replacement by rules that are basically equal with rules of other countries.⁷⁰

Commitment for any of those two harmonization strategies is not absolutely useful. Namely, implementation of strategy based on reciprocity principle assumes that it is previously necessary to establish certain minimal standards without which, in any case, one cannot talk about reciprocity. Moreover, it must be beared in mind that such harmonization strategy does not lead towards standardizing of legal solutions above the level of existing minimal standards, and in such manner leads neither towards elimination of differences among countries, nor towards creation of greater possibilities for comparing stimulations for investment.⁷¹ It makes difficult for investors to compare available options for investment. Therefore, unanimous opinion is that harmonization strategy, based on reciprocity principle, cannot be the basis for globalization (internationalization) of market regulation. In fact, here we cannot talk about globalization of regulatory solutions, but rather on existence of more different systems which share only specific, minimal standards.

On the other hand, opting for harmonization by implementation of the strategy of establishment of certain mutual standards has certain advantages. Main advantage of this harmonization strategy is primarily that it does not lead to regulatory arbitrage problem. This harmonization strategy inevitably leads towards establishment of unique regulatory system of rules, which enables comparison of participants from

70 See: Geiger, Uri, Harmonization of Securities Disclosure Rules in the Global Market: A proposal, Fordham Law Review, br. 66/1998, str. 1794.

71 See: Geiger, Uri, op.cit. str. 1794.

different markets.⁷² This approach to harmonization is not the ideal one. The first question imposed is the question of the number of countries that can be encompassed by this harmonization strategy, as well as the question whether established mutual standards will be applied only to activities in the market consisting of some foreign elements or also when those activities (for example, issue of shares) are enforced solely in national market.⁷³

The main problem regulators are faced with, if they if they opted for this strategy of harmonization, is a problem of defining of mutual standards, which would be not only mutual, but optimal. One of the main disadvantages of harmonization plan and creation of single EU market was exactly commitment for establishment of minimal standards. European directives not only establish minimal standards, but leave member states to choose arbitrarily a certain strategy of rules implementation, which reversibly has as a consequence a huge disparity of legal solutions. Apart from problems of establishment mutual standards, regulators are also faced with the problem of interpretation of the way of their implementation. Thus, for example, almost all capital market regulators emphasize that their objective is to protect investors and maintain market integrity, but they significantly differ on manner of realization of these principles.

Does competition lead to harmonization?

Market globalization put regulators in front of many completely new challenges and imposes necessity of solving numerous issues. Regulatory changes are certainly necessary in order to adjust existing regulatory systems to a global market. In which manner the regulator shall react to challenges he is faced with, largely depends on influence of many, very different and often completely opposite facts.

It is generally considered that regulatory competition and harmonization are two completely opposed regulatory strategies, which, in no case, can lead to mutual objectives.⁷⁴ Globalization of world's market is a strong motive for harmonization and convergence of legal solutions. The capital is the most movable world's resource, which can be electronically transferred worldwide, not only in one moment, but almost free of charge. That is why market regulation can be largely harmonized, because regulators will face the possibility either to make adequate compromises or to expose themselves to risk to be marginalized.⁷⁵ Regulators do not observe regulatory globalization as the best possible solution and they do not want to

⁷² See: Geiger, Uri, Ibid.

⁷³ Regarding detailed discussion on abovementioned questions, see: See: Geiger, Uri, Ibid.

⁷⁴ See: Macey, Jonathan R, Regulatory Globalization as a Response to Regulatory Competition, str. 1375-1376.

⁷⁵ Ibid.

join regulatory globalization due to intention to preserve their sovereignty and own interests, due to which they are not willing to give up their power to control national market, unless they are forced by the threat of complete marginalization.

Although convergence of financial regulation represents the main characteristic of financial integration and regulatory harmonization, complete harmonization will probably not be achieved due to existence of a large number of strictly opposed and competitive regulatory regimes.

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Origins of the global economic crisis (failure of politics or market)

Abstract: *These days many have argued that the current economic crisis is a crisis of the free economy and the proof of the free market's weaknesses. They think the solution lies in greater use of regulations and government intervention in the financial markets. On the other hand, there are many signs that the crisis was created by regulations and government meddling. This has not been a market failure, it has been a failure of politics. The seeds of the financial crisis and the ongoing economic recession were planted years earlier, as policymakers purposefully altered financial market regulations with the intention of promoting U.S. homeownership. Due to this it is crucial to avoid protectionist policies that clog the arteries of economic recovery and help nobody but politicians.*

The causes of financial troubles were expansionary monetary policy moves, particularly following the recession of 2001, social policy that was pursued on financial market and state regulatory interventions. These poorly chosen policies through their impact on interest rates and asset prices, diverted loanable funds into the wrong investments, and twisted robust financial institutions into unsustainable positions. Due to all these, investment banks failed at regular intervals during 2007 and 2008. Short-term credit flows collapsed, jeopardizing funding for mainline businesses and spawning negative economic spiral. Financial sector disruptions have reduced consumer confidence. Now, lower consumption is reducing output, employment, and stock market values, further weakening consumer and financial market confidence. Eventually, trade flows may also be negatively affected if a global recession provokes anti-trade policies as emerging economies seek protection for domestic production.

So the current situation is a financial storm in which governments around the world emerge with numerous bail out plan aiming at restoring fractured financial systems and lost confidence. From a philosophical perspective, any bailout action provides a host of bad incentives. Moreover, in this context it should be kept in mind that future generations already face massive debt burdens. Thus, the ongoing economic crisis, if not properly managed, could give incentives to the permanently higher taxes, greater government involvement in the private sector, and a prolonged period of slower economic growth.

Key words: *global economic crisis, free market, protectionism, bail-out packages, uncertainty, confidence*

Resumee: *In diesen Tagen viele haben argumentiert, dass die aktuelle Wirtschaftskrise eine Krise der freien Wirtschaft und der Beweis des freien Marktes Schwächen ist. Sie glauben, die Lösung liegt in der verstärkten Nutzung von Verordnungen und staatliche Eingriffe in die Finanzmärkte. Auf der anderen Seite gibt es viele Anzeichen dafür, dass die Krise durch Regulierungen und staatlicher Einmischung erstellt wurde. Dies ist nicht ein Marktversagen*

* Institute for Strategic Studies and Prognoses, paper was written in May 2009

ist, hat es ein Versagen der Politik gewesen. Die Samen der Finanzkrise und der anhaltenden wirtschaftlichen Rezession waren Jahre zuvor, pflanzte als Politiker gezielt Finanzmarkt Regelungen mit dem Ziel der Förderung der US-Hauseigentum verändert. Durch diese ist es entscheidend, protektionistische Maßnahmen zu vermeiden, dass die Arterien verstopfen des wirtschaftlichen Aufschwungs und helfen niemandem, sondern Politiker.

Die Ursachen der finanziellen Schwierigkeiten waren expansive Geldpolitik bewegt, insbesondere nach der Rezession von 2001, der Sozialpolitik, die auf Finanzmarkt und Staat regulatorischen Eingriffen verfolgt wurde. Diese schlecht gewählt Politik durch ihre Auswirkungen auf die Zinsen und Immobilienpreise, umgeleitet Kreditangebot in die falschen Investitionen und drehte robust Finanzinstitute in unhaltbare Positionen. Aufgrund all dieser, Investmentbanken in regelmäßigen Abständen während 2007 und 2008 gescheitert. Kurzfristige Kredite fließt zusammenbrach, gefährden die Finanzierung für den Fern-Unternehmen und Laichen negative wirtschaftliche Spirale. Störungen des Finanzsektors haben das Vertrauen der Verbraucher reduziert. Nun ist weniger Verbrauch reduzieren Produktion, Beschäftigung und Aktienmarkt Werte, eine weitere Schwächung der Verbraucher und Vertrauen in die Finanzmärkte. Schließlich könnten die Handelsströme ebenfalls negativ betroffen werden, wenn eine weltweite Rezession hervorruft anti-Handelspolitik als Schwellenländer suchen Schutz für die inländische Produktion.

So die aktuelle Situation ist eine Finanz-Sturm, in dem Regierungen auf der ganzen Welt mit zahlreichen bail out Plan zur Wiederherstellung Aming gebrochenen Finanzsysteme und verlorenes Vertrauen entstehen. Aus philosophischer Perspektive sieht keine Rettung Aktion eine Vielzahl von schlechten Anreize. Außerdem in diesem Zusammenhang sollte bedacht werden, dass künftige Generationen bereits jetzt massive Schuldenlast. So, der anhaltenden wirtschaftlichen Krise, wenn sie nicht ordnungsgemäß verwaltet, könnte Anreize für die dauerhaft höhere Steuern zu geben, eine größere Beteiligung der Regierung in der Privatwirtschaft, und über einen längeren Zeitraum von einem langsameren Wirtschaftswachstum.

Schlüsselwörter: Finanzkrise, Freier Markt, Protektionismus, Notgesetz zur Wirtschaftsstabilisierung, Unsicherheit, Vertrauen

Резюме: *Сегодня многие пытаются доказать, что текущий экономический кризис действительно является кризисом свободной экономики и доказательством слабости свободного рынка. Как считают сторонники этого тезиса, решение кризиса лежит в большом пользовании регулятивов и в государственном вмешательстве в финансовый рынок. С другой стороны, существуют серьезные знаки, что именно регулятива и государственное вмешательство были причиной явления кризиса. Это не была ошибка рынка, а ошибка политики. Источник настоящего кризиса и текущей рецессии появился несколько лет назад, когда политики нарочно решили поменять регулятивы на финансовом рынке, с целью презентации собственности на недвижимость в США. По этой причине, теперь очень важно уклониться от политики протекционизма, которая препятствует экономическому оздоровлению и не помогает никому, кроме политикам.*

Причиной нынешних экономических проблем были экспансивная валютная политика, особенно после рецессии в 2001 году, социальная политика которую водили на финансовом рынке и государственное вмешательство в регулятивы. Эти плохо

выбранные политики повлияли на процентные ставки и цены на недвижимость, направили кредитные средства в ошибочные инвестиции и стабильные финансовые учреждения довели до несуществования. Следствием всего предыдущего, многие инвестиционные банки провозгласили банкротство в течение 2007 и 2008 гг. Краткосрочные кредиты были в коллапсе, финансирование внебанковского бизнеса находилось под угрозой и появилась отрицательная экономическая спираль. Проблемы в секторе финансов уменьшили доверие потребителей. Теперь небольшое потребление уменьшает выход, занятость и стоимость на бирже, дальше уменьшая доверие потребителей в рынок финансов. Все это влияет на токи торговли, особенно поскольку глобальная рецессия может вызвать антиторговую политику, в условиях когда развивающиеся страны требуют защиты домашнего производства.

Поэтому нынешняя ситуация представляет финансовую угрозу, в которой мировые государства применяют планы на спасение уничтоженных финансовых систем и возвращение потерянного доверия. Из перспективы психологии, любая акция спасения дает основы за плохие стимулы. Дальше, нужно еще отметить, что будущее поколения уже обременены высокой задолженностью. Поэтому, текущий экономический кризис, поскольку он не будет урегулирован, мог бы побудить постоянно высокие налоги, большое влияние государства на частный сектор и период пролонгирования экономического роста.

Ключевые слова: *глобальный экономический кризис, свободный рынок, протекционизм, спасание, неизвестность, доверие*

Introduction

Financial crisis in USA has shaken the global economy. Today many believe that the solution lies in the greater use of regulation and government intervention in the financial markets. The supporters of such a view mainly do not discuss the fact that the crisis is the result of the obvious state intervention in the financial market with the aims of social policy. Similarly, it is neglected the fact that in a market with many competitors and without government intervention, the profit motive would never have led to extreme lending to people who cannot pay back their loans. Such behaviour and risk-taking could only be done by Government – with other people's money (tax money), which leads to the conclusion that the crisis was created by regulations and government meddling. The crisis is not a result of the US economy being too free, but comes from the various parts where it has not been free.

The root of crisis is the populist agenda that promoted real estate ownership. According to the *Community Reinvestment Act* from 1977, public authorities are in charge of evaluation of the number of branch offices of banks in low-income areas and how many loans are granted there. If these are considered to be too few, banks run the risk of being sanctioned, via fines for instance. In other words, regulation induces extending credits to people who are unable to redeem them. Genesis of the renewed impetus for increased ownership comes from the President *Bill Clinton*. In

1995 the Clinton administration modified this Law to increase the pressure on banks to grant high-risk loans, without taking into account income and assets adequacy, loan history and other criteria that have to be fulfilled. *Bush* Administration which explicitly promised to promote the so called “*ownership society*,” did not step away from such a policy. Namely, in good economic years, politicians were more interested to get short term advantages by using social policy, rather than taking steps that might prevent potential future crisis. Besides, it is also necessary to emphasize that maybe there has even been a lack of understanding of how important is not to manipulate with the risk calculation on the market.

Such a policy encouraged financial innovations thanks to which mortgage risks were concentrated and after that spreaded and global growth in savings was channelled into the mortgages backed assets in USA (especially on the subprime market). White House and Congress encouraged gigantic, by Government sponsored mortgage firms, *Fannie Mae* and *Freddie Mac*, to spread their activities to the more risky subprime mortgage market through the purchase of mortgage backed papers in contract lacking detailed analysis of the credit worthiness. With the increased frequency at the beginning of XX century, creditors granted a lot of mortgages loans primarily to those with low credit worthiness to qualify for the ordinary banking loans, and such availability of mortgages influenced sharp drop of real estate prices as of 2003, creating a bubble. At the end of 2007, more than 7 million of American households subscribed to the subprime mortgages. The value of those mortgages at that time amounted to \$1,300 billion, by 4 times higher amount as compared to the value in 2003.

However, innovations have simultaneously hidden both scope and location of risk in portfolio of financial assets and have increased the risk of the potential failures in the financial market. Consequently, drop in real estate prices starting as of 2006 increased mortgages default, as well as the risks of their liquidation, created difficulties in evaluation of quality of mortgages backed papers, and the high level of financial leverage of investment banks scared creditors to borrow money to the financial institutions with high-risk exposure to the mortgages backed securities. All this clearly point to the fact that if the attention is more deeply placed upon the origins of the current crisis the following conclusion might be derived: the most distinguished feature of crisis is maybe that it was inevitable.

Breakdown of the current global crisis

The crisis originated in the US mortgage market, specifically in the so-called “subprime” loan market focusing on households with weak credit worthiness. How could subprime mortgages, accounting less than 1% of the world’s debt stock, have caused the greatest financial crisis in modern times?

The process started when the credits were granted to the low income part of the American population and with their transformation to the marketable securities, that is the complex structural products composed of the many subprime mortgages. In this process of *securitization* (conversion of the traditional types of claims into securities) banks formed the so called *special-purpose vehicles* and removed risky assets from own balances to them. In that way investment banks (due to the lack of the classical deposit base they are primarily involved in purchase, selling and trading with risk) were selling bad loans and transferring risk to the buyers of securities and were in the situation to secure less funds for the coverage of credits. Everyone was buying these papers (banks, individuals, funds, corporations) in USA, Europe, Asia, etc. It is necessary to emphasize that securitization by its nature is not negative phenomenon, on contrary; it is perceived as the biggest financial innovation of XX century. However, the process turns out to be somewhat opposite when it is used in excess and when it completely becomes virtual trade (certain banks were even borrowing money in order to create more securitizations), when it is spreaded on the subprime risky market especially in the conditions of maturity mismatch and without taking into serious account the risk of such financing and the quality of credits which formed the basis for creation of structural products. Besides, there is also a belief that neither investors nor issuers understood modern financial techniques: *futures*, *credit-default swaps*, *collateralised-debt obligations*, etc, since they have become highly complex. It is obvious that investors only relied upon reputation of the institutions involved and on the grades of the rating agencies. Due to that, rating agencies had responsible role in the process since they were on the one hand consultants in creation of the structural packages, and on the other hand on the commercial basis provided ratings to products (issue of conflict of interest) and were sending information to market participants about the level of risk they are entering in (ratings were mainly favourable, and, hence, agencies encouraged investments).⁷⁶

Similarly, as in the crisis in Sweden in the 1990s and during America's Great Depression from 1929-33, the current financial crisis also has its origins in Government monetary policy. The USA Federal Reserve cut the federal funds rate to very low levels and below the expected rate of inflation and in that way strongly subsidised credit granting (especially after the *dotcom crisis* in 2001).⁷⁷ As Nobel Laureate *Milton Friedman* explained in a book co-authored with *Anna J. Schwartz*: „By creating deflation through monetary policy, the economic downturn became a

⁷⁶ The goal of rating agencies and investment banks was to give higher grades to securities based on (as it turned out) toxic mortgages. Similar thing has, however, happened in 1990-ies during the Asian crisis when high ratings induced huge inflow of money in the region, and after that sudden turn in rating lead to the catastrophe.

⁷⁷ After recession in 2001, FED chaired by *Alan Greenspan* reduced federal rates from 6,25% to 1,75%. Further reduction occurred in 2002 and 2003, when the rates were reduced to the record low level of 1%. This has increased liquidity in the economy and slowed down economic downturn, however, it created the massive demand bubble.

depression".⁷⁸ So, policy of cheap money in USA and the increased demand for American financial assets from Asian nations encouraged growth of the real estate prices, which altogether had the effect to the investors' expectations that such situation won't change. Consequently, more risk was taken and credit activity increased and, thus, the majority of subprime mortgages with flexible rates was created in the period of low interest rates. However, with the drop of real estate prices, problems emerged, granting credits was slowed down, and in certain cases even stopped, stock markets plunged and the *crisis of confidence* occurred. With the drop of prices of stocks creditors asked for return of funds and many banks did not have enough capital that might have been used as a shelter against unexpected losses. Also, they did not have deposit basis and all this very fast created collapse and dramatic situation.

Moment when the panic burst and the crises accelerated all round the world was the moment of the greatest bankruptcy in the corporate history of USA, and that is bankruptcy of the bank *Lehman Brothers*. USA Government by allowing collapse of this bank, warned markets that moral hazard in behaviour of banks was seriously taken into consideration. Bank bankrupted with \$613 billion worth debt (\$160 billion of unsecured bonds in the hands of investors around the world who mainly relied upon the high rating of *Lehman Brothers*). The entire cost of this bank failure, in terms of the damage caused to creditors and trading partners is yet to be determined.

It turned out that this bank was systematically important („*too big to fail*“), for after its bankruptcy, the whole segment of investment banking was erased from the banking map of USA. The remaining banks: *Bear Sterns*, *Goldman Sachs*, *Morgan Stanley* and *Merrill Lynch & Co*, were transformed into commercial banks.⁷⁹ *De facto* freezing of the global inter-banking market due to the loss of confidence following the collapse of the *Lehman Brothers* slowed down global activity because the access to short-term financing necessary for production has disappeared.⁸⁰ Many

⁷⁸ Significant difference between the current episode of recession and those in the post-war period is that this time financial sector is massively disturbed. During the previous recessions, well functioning financial sector was playing crucial role in easing economic revival, because it channelled funds to more profitable enterprises and was cutting credits to those who were less efficient in economic terms. The previous two recessions in 1991 and 2001 occurred under the healthy economic fundamentals: highly productive workforce, strong growth of consumption, continued advancement in the global trade and low taxes. This time, however, it seems that these fundamental forces are significantly weaker.

⁷⁹ Following the Great Depression in 1929/33, *Glass Steagall Law* was adopted and in accordance with it investment and commercial banks were separated. The irony is that today investment banks are transformed into commercial banks, that is they are being taken over by them.

⁸⁰ Today, banks mainly redeposit money at the respective Central Banks. It should be taken into account that once the banks redeposit money borrowed from the Central Bank, they do that at the rate that is lower than one at which money was borrowed originally. The loss that banks purposely make

banks in emerging countries were faced with the financial difficulties although their exposure to the problematic assets in USA was limited. Despite the fact their Central banks were holding significant reserves in foreign currencies, they were neither capable nor willing to supply them with \$, which has lead to the misallocation and more restrictive credit policy. Automatically, individuals and firms felt that and world economic crisis began.

Social policy on the financial market (the role of Fannie Mae and Freddie Mac)

To understand the current economic turbulence, it is necessary to study the two American credit institutions which played a decisive role in its creation: *Fannie Mae* and *Freddie Mac*. *The Federal National Mortgage Association*, a k a *Fannie Mae*, was founded by the US federal government after the Great Depression. Over time it evolved into a private credit institution which simultaneously had the status of a government entity. The business of Fannie Mae mostly consisted of taking on financial responsibilities and hedging against the losses on loans granted by other credit agencies. *The Federal Home Loan Mortgage Corporation*, *Freddie Mac* was created in 1970 with the same basic structure and purpose as *Fannie Mae*. American Government gave a task to these public institutions to make easier for the low income households to become real estate owners. Until September 2008, these institutions had peculiar design. On the one hand, they were government entities with political goals for which they received substantial subsidies; on the other hand, they were private businesses seeking to maximize shareholder value. It might be said that *Fannie Mae* and *Freddie Mac* have increased risk-taking in the mortgage market in the three ways:

- Tax money channelled via *Fannie Mae* and *Freddie Mac* encouraged high-risk loans. Drawing on hefty subsidies, these two institutions guaranteed mortgages granted to those individuals who did not qualify for ordinary loans.
- The implicit knowledge that the Government would step in to save *Fannie Mae* and *Freddie Mac* in case of significant problems (hypothesis that turned out to be true on September 7th 2008 when the Federal Government was forced to make those implicit guarantees explicit), which lead to the overestimation of the securities, which means that the rates on mortgages were significantly lower as compared to those on the free market.
- The benefits granted by politicians to *Fannie Mae* and *Freddie Mac* enabled them to increase rapidly, enjoy in profit margins and crowd out ordinary credit

in order to save the part of their funds indicates the fear present among them when it comes to the mutual business activities.

institutions at the free market, and such dominant role of them made their mistakes fatal.⁸¹

The two institutions were taken over by the federal authorities on September 7th 2008, as both of them were very badly hit by the crisis to which they had largely contributed. It should be mentioned that these institutions in the preceding months had been in charge of 70% of the mortgages in the United States, which provides an indication of their decisive role in the market where the crisis first occurred.

When *Fannie Mae* and *Freddie Mac* were small, risk they represented to the stability of the financial system was limited. Since they increased over the time, thanks to the tax payers' money, it was necessary to limit their roles on the market. Even the ex President of FED, *Alan Greenspan* warned that *Fannie Mae* and *Freddie Mac* through their subsidized activities have created social advantages at the mortgage market.⁸² But there was also support for this policy within the private financial sector. Private banks saw that loans which ordinarily would be too risky became profitable once they were subsidized by tax money and guaranteed by institutions backed by the Government. Hence, it is clear that these two institutions with their hazardous behaviour supported some of the biggest levels of financial exposure in financing and securitization of mortgages, including that subprime. The irony is that despite mandate given by Government to reduce the costs of households' ownership as well as systematic risk *Fannie Mae* and *Freddie Mac* were holding, motive that dominated over their activities was primarily to maximize profits of their shareholders.

Over the years economists have been arguing that the risk created by these institutions is huge as compared to the potential social benefits such a policy might bring about. In the book *Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks – Why and How*, by authors *Peter J. Walison Thomas, Stanton i Bert Ely*, published in 2001, the following was concluded: "*The government sponsored companies in the housing market contribute very little to the quality of the financial system for housing in the USA, but create risks for the taxpayers and the*

⁸¹ Beyond *Fannie Mae* and *Freddie Mac*, there are *federal home loan banks* in the United States. These were created after the Depression and, like *Fannie Mae* and *Freddie Mac*, they are tax-financed credit institutions and they lend money to other banks which in turn provide mortgages to private individuals. These companies use tax subsidies to reduce the cost of mortgages and have thus also contributed to the excessive credits in the US mortgage market.

⁸² Over the years, numerous critics have warned about the financial crisis which the *Fannie Mae* and *Freddie Mac* could create. An example is an article published in the *New York Times* in 1999 and which describes their use in order to reduce credit restrictions for mortgages: "*By expanding the type of loans that it will buy, Fannie Mae is hoping to spur banks to make more loans to people with less-than-stellar credit ratings.*" This was motivated by the wish to "help increase home ownership among minorities and low-income households" responding to pressure from the Clinton administration.

economy as a whole which cannot be resolved by regulation". Unfortunately, only now is realized that the entire policy of promotion of real estate ownership was excessive. Even in the situation of the complete domination of opinion that it is worth encouraging real estate ownership, that mortgage debt has to get subsidies and that structure of these institutions was sustainable, allowing them to take the dominant role in financing mortgages was a mistake. With them becoming bigger and bigger, financial market was becoming more and more unstable.

At the market, creditors and investors take care that those who borrow the money are on the healthy economic footing. Activities of *Fannie Mae* and *Freddie Mac* have, however, made impossible for market mechanisms to work properly. In their case market discipline was poor or not existent. This was due to the fact that many participants in transactions with these institutions calculated risk almost entirely in accordance with the perceived special relationship the institutions had with the state, instead of on their basic stability, which means that regulators could not rely upon market discipline in order to overcome the risk.

Information asymmetry – free market disturbance

As it turned out, investors were relying upon credit ratings in excess. However, in conditions of deterioration of credit fundamentals, it became almost impossible for many complex and multilayered securities to be estimated, and the market liquidity disappeared once the highly financially exposed investors (mainly hedge funds) reduced their exposure.

Uncertainty comes from the same origins as the crisis, that is from the complex process of securitization thanks to which banks firstly packed and after that sold their credits in the form of structured bonds. In this process, only roughly synthesized information about credit portfolio were channelled to the market. Hence, there was significant loss of information that might have helped in evaluation of credit risk of those portfolios. Bearing in mind that structured bonds and derivatives created based on them were mainly bought by banks, insurance companies and trust funds, uncertainty regarding their value was transformed into uncertainty regarding the scope of losses and toxic assets hidden in bank balances, and that made hard or even impossible for some of them to get liquid funds or fresh capital. Really, extreme uncertainty created fear, and fear created paralysis, which is the best illustrated with the *Lehman Brothers* case. This bankruptcy is the example of information asymmetry, that is of uncertainty about the quantity of risky assets in its balance.⁸³ Hence, it could not be known whether the bank would be solvent in the

⁸³ When *Lehman* was faced with the problems, British bank *Barclays* was the only one that showed an interest to buy it, but due to the fear that its balance hides more losses as compared to the

case its assets and liabilities were properly estimated. Politicians allowed failure of this firm because they believed that market participants had enough time to notice its weak financial perspective and to protect their assets. Unfortunately, *Lehman's* partners did not react, because they were probably expecting Government bailout (e.g. as in the case of *Bear Stearns*).

Uncertainty generated by the lack of transparency was also the root of market illiquidity. As of June 2007, the market of structural bonds is basically frozen and even liquidity on money markets is hardly available. The reason hiding behind this is also a fear created by uncertainty: investors were scared to purchase securities which might hide a lot of insolvent credits, hence, they preferred holding liquid funds in their hands. At the end, such market paralysis worsened situation of banks, making their assets illiquid and forcing them to reduce granting credits. The lack of knowledge about the distribution and location of the risky assets in financial firms has led to the risk augmentation. Limited credit flows towards financial and non-financial firms have worsened economic performances and increased risk from default.

But what explains behaviour in the origin of this catastrophically uncertainty, that is what explains destruction of the great amount of information which are relevant to the prices in the securitization process and granting of ratings to structural bonds? The answer is the following: by simplifying information channelled to the market, banks increased the scope of the market for the structured bonds they issued. In the case of detailed and complex information provided they would reject many non-sophisticated investors, which would have been in the worse situation as compared to those in position to process these information. Hence, greater transparency would force issuers to reduce the level of securities issue or to accept less liquid primary market, which would reduce their revenues, as well as the revenues of the rating agencies. Instead of that, they preferred to increase primary market as much as possible, even if that would jeopardize stability and liquidity of the secondary market.

Although firms specialized for production of information on credits and the quality of those who are lending money, on rating of the securities and the profiles of risk, are in charge of making necessary evaluations and monitoring that are too expensive to be done by individuals and even institutional investors, current financial crisis is characterized by the evident failure or the lack of will of rating agencies to secure reliable information on quality of mortgages backed securities. Hence, market players did not have proper information or the signal based on which they were making their investment decisions. And with limited and insufficient information it is hard to speak about the free market environment.

published figure, *Barclays* asked for risk guarantee from American Treasury. When the Treasury refused to give guarantee, *Barclays* stepped away and *Lehman* failed.

Deregulation vs. Regulation in USA

The last three decades were characterized by the significant deregulation of USA economy, but not in the financial sector, which means that almost the entire financial legislation adopted after the collapse of savings and credits in the late 1980-ies, was based on the much tougher regulation.⁸⁴ Even during the previous financial crisis, interpreted as the proof of the capitalism failure, regulation and Government intervention were responsible for many problems. Swedish financial crisis during 1990-ies showed some similarities with the one hitting USA today. Interest rates were very low, which means that credits were subsidized by the Government. Many Swedish people were willing to accept even riskier credits in order to buy, among other things, real estate. When the crisis hit real interests, the real prices of real estate plunged and real estate bubble burst. Soon after that bank credibility sunk and the crisis broke. Combination of the policy of fixed exchange rates and the long term inflationary economic policy (both politically created), lead to the very serious recession.

One reason why financial crises originating in the United States superficially may be interpreted as a crisis for the free economy is that the country enjoys a high degree of economic freedom. In a nutshell, USA experienced strong economic growth that resulted from the series of reforms, which has increased economic freedoms and lead to the increase in wealth that will remain even after the current crisis. United States rates a superior position in the *Index of Economic Freedom* in terms of various aggregate indicators. Still, there are parts of the US economy which are not free (in terms of financial markets, the economic freedom in the US is on par with that of many European countries), which means that in the recent years the US has stagnated and even experienced a loss of economic freedom, resulting among other things from new regulations hitting industry (e.g. *Sarbanes-Oxley* following a few scandals and collapse of the *WorldCom* and *Enron*, as well as increased public expenditure). Contrariwise, Europe has enjoyed greater economic freedom. The crisis has therefore occurred in the United States with regulated financial markets and in recent years decreasing economic freedom. That regulation played significant role in creation of the current crisis, since there were only a few institutions evaluating risk taking in relation to the credits granted on the market. This oligopoly market was poorly equipped to measure risks as compared to the freer market with more players. Unlike certain forms of regulation and the Government intervention in

⁸⁴ The libertarian commentator *Johan Norberg* asks in the Swedish daily *Expressen*: “Shouldn’t we for a start study the tens of thousands of pages of regulation already existing and what the 12,190 individuals who spend all their time regulating the financial markets only on the federal level and what they did when this happened? Once this is realized, it will be clear how much they contributed in encouraging creation of bubble.”

financial markets which aim to reduce risk taking, regulation in the USA mortgage market aimed at encouraging risk taking. Although the crisis in USA was in the great extent created by the Government intervention and regulation, these instruments are now perceived as a remedy.

Bailout packages

Poor will of participants on financial market to borrow funds or to trade with institutions holding significant quantities of toxic securities disturbed credit flows between banks and non-banking financial institutions. Complex and multilayer structure of financial contracts regarding securitization and insurance of mortgages concentrated in packages of the structural products, makes their estimation harder and contributes to the drop in market transactions with these securities. Due to the consequent lack of funds, cycle of cash injections to the banks was put in place by the Governments around the world. Hence, today more than ever protectionist wind is blowing in all parts of the world and it could induce some states to narrow the scope of market mechanisms that help economies to become efficient.

Thanks to the actions of European and USA Governments, that adopted so called „*the bail-out packages*“, granted guarantees to the banking debts, secured liquidity for short-term borrowing and partially nationalised banks, etc, banking sector is the industry which has been reshaped with the speed of sound, more than any other in the recent economic history. However, since these are extremely complex measures to implement, the implementation has been far from perfect. These funds in some countries were almost at the level of their annual budgets. However, although dealing with the short term resolution of the liquidity problems, these packages are not dealing with the collapse of confidence in financial system, because none intervention of pumping up the money in the system can resolve that, since they do not address capital non-adequacy.

In the absence of almost any refusal politicians were given mandate by the public to implement sanation packages with the taxpayer's money due to the understanding that banks, the same goes for the remaining part of the financial system, including capital market, are important. When banks efficiently mobilize and allocate funds, they reduce cost of capital and accelerate accumulation of capital. When banks allocate credit to entrepreneurs with best ideas, productivity increases and more people might transform their economic dreams into the reality. Finally, when banks cautiously manage the risk, the likelihood of the systematic crisis is reduced.

Precisely, bailout plan for banking system in USA approved by the Congress in October 2008 in the amount of about \$700 billion (5% of USA GDP) was initially imagined in the way that funds have to be used in order to purchase financial assets that lost its value when the real estate bumble burst (mainly subprime mortgages backed securities, which are in the hands of banks and other financial institutions).

However, spending plan of at least \$250 billion of allocated funds is used for the purchase of preferred shares in banks and other financial companies. That, however, does not eliminate toxic assets from the books in that companies, although in the short run provides firms with the additional capital in the hope they will re-establish credit transactions towards non-financial business and in this way bring back financial sector into the normal state. Still, program is not dealing with the crucial origins of the loss of confidence.

Supporters of the bailout satisfied necessary condition for the state intervention, and that is that there is certain failure in financial sector which might cut market mechanisms of self correction, resulting into the significant damage caused to the both national and world economy. Furthermore, there is certain theoretical finding according to which it is believed that bailout plan might respond to the credit crisis and reduce seriousness of recession. However, there are a few reasons why it is believed that the bailout will be inefficient. Namely, sceptics of the bailout believe that ailing financial firm should be left to the bankruptcy. They believe that as quickly as they experience the collapse and their assets be acquired by healthier competitors, the faster the financial sector might be restructured and will return back normal credit flows which are vital in the long run. From this perspective, bailout will only postpone proper revaluation of assets and revival of normal credit flows and prolong recession which started when the real estate bubble burst. As long as the market forces are not allowed to eliminate insolvent financial companies via bankruptcy, restructuring and reselling, long term economic revival cannot start.

Surely, whenever financial crisis occurs, there are arguments to manage it politically. However, at the same time there is also a risk that the financial sector will realize that Government will prepare bailout during the next crisis and that is why it continues too risky behaviour and creates spiral of moral hazard. Activities of the USA Treasury and FED so far were not successful and is unlikely they will restore market confidence. Instead of that, current initiatives seem poorly designed, and they are pumping more uncertainty into the markets, instead of re-establishing confidence of participants. Worse than that, current interventions in market processes and institutions might become permanent. From the psychological perspective, each bailout provides bad incentives and prolonged period of slow economic growth. Finally, recovery from the financial crisis will be certainly slow with or without bail-out by the state, with or without bailout current recession is likely to be deep and longstanding.

It is easy to call for the more regulation during the times of crisis. However, due to the numerous reasons, there should be caution as regards excess regulation of financial markets. For the beginning (and that is essential) free markets are basis for the wealth creation all around the world. Relatively free financial markets played almost decisive role in making economic development possible all around the world.

Studies have established connection between the degree of competitiveness and the openness in financial sector and economic growth of countries, which is also strengthened by the effects of globalization in financial sector. With the spread of free markets to the ex socialist countries in Eastern Europe, as well as China, Vietnam and India, financial markets had decisive role in lifting hundreds million of people out of poverty during the last years.

However, the following fact, which is also advocated by the economic school of public choice, has to be clear, public interest is not always the focus of political decision making. In fact, regulatory policy is not only based upon reasonable basis. Politicians and state officials in charge of the regulation development are conditioned by individual interest and ideological preferences. Motivation hiding behind regulation and public interference in economy is the increased power of politicians and authorities; followed by the satisfaction of the aspirations of numerous lobby organizations.

In any case, if bailout measures in USA and European soon do not mend financial instability (and there are strong reasons for the doubt) politicians will probably intensify efforts for revival financed by debt and will increase implicit fiscal burden for the future generations of tax payers. Consequently, if the current financial crisis metastases, tax basis will erode, tax rates will permanently become higher, state interference in the private sector will increase and the economic growth will be slowed.

Conclusion

The financial sector must be stable, credible and transparent but it can't balance the shortcomings of other parts of the economy. If monetary policy isn't stable, if public finances are unstable or if political interventions undermine the market, the market can't compensate for that. And no one can avoid the consequences of an economical downturn.

There will always be downturns in the economy and risks of bubbles being created in markets. But rushing into the ideas of *Karl Marx* or *Jean-Baptiste Colbert*, as seems very popular these days, is not the solution to any of that. Free markets are an unprecedented engine of prosperity, and freer financial markets have been essential in the global boom of the past decades. And really, it is necessary to insure proper functioning of markets in the future, in order to fit into the reality of global economy. If today markets are regulated in the way that will hurt the vitality and innovations in the areas of trade, entrepreneurship and investments, the opportunities will be lost and stability won't be established. Surely, a lot has to be done in order to achieve better regulation, but certainly that does not mean more regulations (something that is commonly suggested in today's debate). The increasing role of

the state in today's financial crisis destroys competitiveness and reduces confidence into the future economic growth.

It might be concluded that global financial problems are not result of the one mistake, but of many mistakes (the so called. „systematic mistake”). Still, how things stand no one was in the position to estimate built in „systematic risk”, that is to take care of the risk augmentation for the entire financial system in the case of the drop of real estate prices. It is clear that the problem of location and distribution of mortgages maybe is not so important for investors when real estate and many other economic branches are booming. Positive performances of the majority of credits in such a situation compensate for probably minimal losses on problematic mortgage credits. Risk from default remains to be low and the real estate owners still benefit from the boom in real estate prices, which means that in such a situation problematic mortgage backed securities in that situation might be sold easy and with profit. When the real estate bubble burst, however, the exposure of mortgage backed securities significantly increased and the issue of location of such credits suddenly became very important both for investors and insurers, all with the view to maintain confidence in the overall credit activities.

In the context of the current drop of the real estate prices, it might turn out that majority of investors and financial companies is exposed only to the low amount of risk (subprime) mortgage backed securities. However composition of portfolio of companies is not public information. Possibility that someone's partner in transaction is exposed to significant risk stemming from the real estate sector, modifies behaviour and the will of financial firms to lend money. In that context, crucial question is the following: do even politicians understand that once when the systematic shock is in the move (situation when the degree of financial leverage is reduced by withdrawing, selling of investments of financial firm in order to get cash and consolidate capital basis), investors and other market players are especially vulnerable to the news about financial sector and perspective of the economy. Any announcement about the worsening of market and economic perspective might become self-fulfilling. It is obvious that policy makers are not aware of that, and are instead short-sighted and do not understand causes and origins of concrete problems. Still, once the current financial storm calms down, it will be of crucial importance to determine what has actually happened. And behind debate on the future policy there will be just debate on causes and origins of crisis.

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Fiscal Policy (Mis)use in times of the crises

Abstract: *The recent history represents a marvelous laboratory for studying the economic interdependence, causes and results. In the light of the above, this paper starts by reminding of the Great Depression (GD), the institutional environment preceding it, review on the current World Economic Crisis (WEC), as well as the common causes, cures and consequences of these two most important crises of the recent history. The comparative approach and relevant empirical research can be of great assistance in better understanding of this process. Therefore, the paper provides for the results of relevant researches on the consequences of the crisis.*

The paper is focused on (mis)use of fiscal instruments in the conditions of the crisis. Crises are used as for justifying and surge in increase in public spending. The same situation happened during and after the Great Depression from the past century, as it is nowadays while facing the World Economic Crises (WEC). Once increased, the public spending is difficult to alter in opposite direction. This occurs really in the history. Even if the increased spending would return into the state it was before, this process would leave major consequences, among which the most visible, but not the most painful one is the public debt burden imposed to future generations.

Although there are few arguing the inefficiency of Keynesian answer to the crises from XX century, and researchers are finding in the consequences of that crisis reason of current crisis, similar solutions are often given. Market is mostly presented as unfixable evil, driven by greed and activities of uncontrolled and unregulated speculates and the state is only one which can and should save poor victims- citizens (voters). Driven by the pressure of public that the state should solve economic crisis, to do something and not just to stand, the decision makers are competing by size and extent of fiscal stimulants.

Key words: *Great Depression, World Economic Crises, Discretion Fiscal Policy*

Resumee: *Neuere Geschichte stellt ein ausgezeichnetes Labor zur Erforschung von wirtschaftlichen Zusammenhängen, Ursachen und Folgen dar. Diese Arbeit beginnt daher mit Rückblick auf Große Wirtschaftskrise (GWK), das ihr vorangegangene institutionelle Umfeld, mit Erörterung der aktuellen Weltwirtschaftskrise (WWK), sowie auf gemensame Ursachen, Heilmittel und Folgen dieser zwei, nach dem Ausmaß, bedeutesten Krisen, die neue Geschichte bezeichnet. Ein komparativer Zugang und relevante erfahrungsgemäße Forschungen können viel einem besseren Verständnis dieses Prozesses beitragen. Deswegen wurden die Ergebnisse der zugänglichen Erforschungen der Folgen von Finanzkrisen dargestellt.*

Fokus der Arbeit beruht auf (Miß)-Brauch von steuerlichen Instrumenten bei Krisenumständen. Die Krisen werden als Rechtfertigungen und Anlässe zum Anstieg des staatlichen Verbrauchs benutzt. So war es während und nach dem GWK aus dem letzten Jahrhundert, und so ist es auch heute im Rahmen der Konfrontierung mit WWK. Einmal

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erhöhter staatlicher Verbrauch lässt sich später schwer rückkorrigieren. Dies ist eine sehr seltene Erscheinung in der Geschichte. Und wenn es sogar möglich wäre, den erhöhten Verbrauch innerhalb einer kürzeren Zeit in frühere Grenzen zurückzubringen, hinterlässt dieser Prozess schwere Folgen, unter denen die erkennbarsten, doch nicht die schmerzhaftesten, die Last der Staatsschulden für künftige Generationen ist.

Obwohl kaum jemand die Unwirksamkeit der keynesianischen Antwort auf die Krise aus dem XX. Jahrhundert bestreitet, und die scharfsinnigen Erfinder finden in Folgen dieser Politik die Ursachen derzeitiger Krise, ähnliche Rezepte werden als heilsam angeboten. Der Markt wird hauptsächlich als eine unverbesserliche Übel dargestellt, der von Habgier und Begeisterung der unkontrollierten und ungeredelten Spekulanten geleitet wird, und allein der Staat ist derjenige, der arme Opfer – Bürger (Stimmabgeber) retten und sollen kann. Geleitet vom Druck seitens der Fach- und Laienöffentlichkeit, daß der Staat mit der Krise zurechtkommen, irgendwas tun sollte, um nicht nur mit den „gekreuzten Händen zu sitzen“, rennen sich die Entscheidungsträger in Umfaßlichkeit und Umfänglichkeit der steuerlichen Förderung.

Schlüsselworte: *Große Wirtschaftskrise; Weltwirtschaftskrise; diskrete Steuerpolitik*

Резюме: *Новейшая история представляет собой прекрасную лабораторию для изучения экономической взаимозависимости, её причин и последствий. В соответствии с этим, в начале данной работы уделяется внимание экономическому кризису, учитывая институциональные условия, которые предшествовали кризису, замечания по вопросу нынешнего мирового экономического кризиса, а также общие причины, средства защиты и последствия, с точки зрения два серьезных кризисов, которые новая история запомнила. Сравнительный подход, а также и соответствующие эмпирические исследования, могут помочь лучше понять этот процесс. Таким образом, представлены результаты исследования по изучению последствий финансового кризиса.*

В центре внимания данной работы приведены налоговые инструменты, которые злоупотреблены в период кризиса. Кризисы использованы в качестве оправдания или предлога для увеличения государственных расходов. Это было во время и после великого экономического кризиса прошлого века, и сегодня, во время мирового экономического кризиса. Раз увеличенные государственные расходы трудно настроить позже. Это очень редкое явление в истории. И в случае, когда увеличенные расходы можно вернуть в предыдущие пределы в течение короткого времени, чтобы ограничить этот процесс, это оставляет серьезные последствия. Из этих последствий выделяется, больше всех, бремя государственного долга для будущих поколений.

Хотя лишь немногие оспаривают неэффективность «кензийского» (вмешательство и влияние государства на экономию) ответа на кризис в двадцатом веке, проникательные исследователи ищут причины в плане определения последствий такой политики. Чтобы найти причины нынешнего кризиса, подобные рецепты предлагаются в качестве спасительных. Рынки в основном представлены как непоправимое зло, и только государство может и должно сохранить бедных жертв - граждан (избирателей) от жадности неконтролируемых и нерегулируемых спекулянтов. Под давлением специалистов и широкой общественности в борьбе государства с экономическим кризисом, чтобы сделать хоть что-нибудь, и чтобы не

«сидеть сложа руки», лица, принимающие решения, участвуют в гонке за увеличение объема налоговых стимулов.

Ключевые слова: большой экономический кризис, мировой экономический кризис, дискреционная фискальная политика

Great Depression (GD)

Bernanke⁸⁵, the Head of the U.S. Federal Reserve, is the author of the Essay on the Great Depression, presenting his and other conclusions and perceptions on the Great Depression. Bernanke is stating that proofs are indicating that the “Severe Contraction” – world’s shrink in aggregate demand in 1930, was, to the greatest extent generated by the monetary shocks⁸⁶, spreading worldwide, primarily through the gold standard⁸⁷. According to Bernanke, there is a widely accepted opinion that the U.S. Federal Reserve policy in 1928 was contra-cyclic (restrictive), intended to correct capital markets speculations. The narrowing of the monetary base, with simultaneous increase in the gold inflow in the period June 1928 – July 1930, has led to a significant decrease in the *money-gold ratio*. The fall of the *Kreditanstalt*, the biggest Austrian Bank in May 1931, has triggered the banking panic and foreign currency crises. This generated the decline in the aforementioned money – gold ratio, i.e. significant decline in cash in circulation, subsequently causing the decline in property prices (shares, real estate, etc.).

The general prices decline negatively affected the entire economy, especially the banking sector. This fall led to the decrease in the value of the borrowers net assets, subsequently decreasing the collateral. When the collateral is below the debt value, the loan is exposed to the greater risk of timely servicing. Business activities, once economically justified prior to the fall in general prices, are being reexamined, creating the situation in which the borrowers are failing in servicing loans from their regular business activity. The inability to service loans, along with the inadequate collateral, is generating adverse effects to the bank’s capital. Simultaneously, market disturbance causes the pressure on deposits withdrawal, subsequently decreasing the

⁸⁵ Ben S. Bernanke, *Essays on The Great Depression*, Princeton University Press, 2000.

⁸⁶ „New research on gold standard is allowing us to justifiably claim that monetary factors have played an important causal role, both at the time of the world’s decrease in prices and production and its recovery”- B. Bernanke, page 7.

⁸⁷ Suspended during the First World War, the gold standard was restored after the war: Great Britain returned to the prewar gold standard in 1925, France fully returned in 1929, when the gold standard was virtually universal among market economies. Return to the gold standard was emphasized and praised as the main diplomatic achievement and an essential step towards the reestablishment of a stable monetary and financial system, which featured the period of 1870-1913 (the classical gold standard period). However, in 1931 it was clear that the desired financial stability failed to be achieved, but the world was consumed by the financial panic, which was characterized by the exchange rate crises, thus most countries have abandoned the gold standard.

credit base for new loans, decreasing the money multiplier, and the cash in circulation thereon. The banking sector problems have generated the weakening of the entire financial system, being less efficient. Financial mediation expenses grew, and the quality of services fell, thus both the individuals and companies were facing difficulties in obtaining expensive loans. This generated the additional decrease in the crediting volume causing additional decrease in the cash in circulation.

Simultaneously with deteriorated situation in the financial sector, especially the banking one, the contraction has spread to the real sector. Financial sector disturbance has increased the real creditor – borrower mediation costs. Not only that the loans became unavailable, they became expensive. Projects which at prosperous times could be smoothly financed, they become difficult to finance at the time of the crises even at the higher price. It happens often that even good projects fail to be financed. Thus the banking crises⁸⁸ is more likely becoming the economic system disorder.

To summarize, two factors have mostly affected the fall of the banking sector. The first one was the increase in “bad loans”, i.e. increase in outstanding liabilities to banks and deposits withdrawal⁸⁹. The period that preceded the crises, has recorder the sharp increase in debt at all levels – citizens, entrepreneurs, large companies, municipalities and government.

Aforementioned three paragraphs are describing the U.S. banking and economic system collapse eighty years ago, during the Great Depression. They could literally relate to any economy affected by the current crises, including Montenegro. One would say, that the history (cycles) is relentlessly repeating, and others that the history has thought us nothing.

The Reminiscence of Previous Financial Crises

The recent experience is indicating that the main financial crises aftermaths are the long – term negative consequences. By analyzing the biggest “modern“ financial shocks, Reinhart and Kenneth⁹⁰ have found that the banking crises⁹¹ in rich and

⁸⁸ Percentage of banks that went bankrupt in the United States during the period 1930 – 1933, amounted to 5,6; 10,5; 7,8; and 12,9, respectively. Due to the collapse and merge, the number of banks in 1933, against 1929 was almost halved, and the remaining ones suffered huge losses. The bankruptcy wave reached its peak at the fall of the banking system in March 1933.

⁸⁹ B. Bernanke, page 44.

⁹⁰ Carmen M. Reinhart and Kenneth S. Rogoff, “The Aftermath of Financial Crises”, December 19, 2008.

⁹¹ “Five great“ banking crises erupting after the Second World War were recorded in developed economies and relate to the following ones: Spain 1977, .Norway 1987, Finland 1991, Sweden 1991

emerging markets⁹² have surprisingly many similarities. They have a very similar pattern in the trend of the real estate and shares prices, unemployment, national income and state debt.

There are three negative commonly prevailing trends in both developed and emerging economies. The first one is that the real estate prices are falling at the average by 35% retaining at the low level for over six years, while the shares prices are falling at the average by 55%, and negative trends last for about three and a half years. The second one is that the consequences of the banking crises are associated with a sharp decline in the overall economic activity and employment. The unemployment is growing at the average by 7 percentage points in the course of the negative phase of the cycle, which lasts for about four years. Especially pronounced negative consequence relates to the decline in the real gross domestic per capita, at the average by over 9%, for an average period of two years. The third one is the explosion of the real value of public debt, growing at the average by 86% in most of the crises that occurred after the Second World War. The biggest part of this expense is not directly linked to the rescue of troubled banks through nationalization and redemption of bad debts, or assuming the payments of guaranteed deposits, it is more the result of a prolonged recession and fiscal expansion, designed to counteract the crisis. Primarily, the cause is an inevitable tax revenues collapse, being the result of a deep and prolonged economic activity contraction and often ambitious contra-cyclic public spending intended to soften the landing.⁹³

The question is how, to what extent these data may be used as a benchmark for the current banking and economic crises? The answer is difficult because even if observed as the same process, all examples of analyzed crises were more isolated ones while the current economic crises is rather a global one. In the light of the above, the battle in counteracting it is more complicated and the crises is leaving unpredictable consequences. Some countries after "only" few months of facing the crisis are recording the most negative decline values of the real estate, shares, GDP, employment and other indicators, and many are predicting that the worst is yet to come. Thus the alarm and anxiety among citizens and decision makers is not surprising, as well as the growing pressure to undertake actions to stop the avalanche of negative trends.

and Japan 1992. the most important crises that hit the emerging markets relate to the following: Asian crises in the period of 1997–1998. (Hong Kong, Indonesia, Malaysia, Filipinas and Thailand), Columbia 1998 and Argentina 2001.

⁹² There isn't a "commonly accepted" translation for the „*emerging markets*“. This term is usually translated into our language as the rising economies or fast – growing economies. In this document both terms will be used as synonyms.

⁹³ Carmen M. Reinhart and Kenneth S. Rogoff, "The Aftermath of Financial Crises", December 19, 2008.

The experience should teach us on how we should economically (not)react not just to prevent the crises but to tackle it when it erupts. The current World Economic Crises is implying that, regardless of the accumulated knowledge and understanding, it is difficult to predict the economic cycles of the Great Depression, being less predictable. Moreover, known and proven, as well as new creative measures to face with the crises are considered more harmful than useful. The rest of the document is focused on these issues.

World Economic Crisis

The IMF's World Economic Outlook from October 2008, starts with the following statement: "The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s"⁹⁴. After years of the strong GDP growth⁹⁵, accelerated trading with goods, services and technology, as well as the increase in investments volume globally, the world economy is rapidly decelerating⁹⁶.

Deceleration was preceded by great turbulence on the food and industrial products market, especially fuels. As of 2004, the food and fuel prices have exploded, reaching record levels in 2007⁹⁷. Nonetheless increase affected the real estate and shares market. Decision – makers were worried and citizens were frightened by the growing inflation. All attention was focused on its curbing.

The financial crisis erupted in August 2007, with the U.S. subprime mortgage collapse. Up to September 2008, the global confidence in financial institutions was completely ruined. The most dramatic downturn occurred in the banking sector solvency generating the bankruptcy of then the biggest and most prestigious banks,

⁹⁴ World Economic Outlook - Financial Stress, Downturns, and Recoveries, International Monetary Fund, October 2008, page. 1.

⁹⁵ By summer 2007, the worlds GDP has accounted for the average growth rate of 5% four years consecutively, which is the highest growth from 1970.

⁹⁶ In the period from forth quarter 2007 – second quarter 2008, the recorded growth was only 1% in developed economies in comparison with the growth of 2,5% in the first three quarters of 2007.

⁹⁷ The sharp growth in food and oil prices has led to the comprehensive fiscal agreement answer in most countries. The IMF's study has included the "answer" in 161 countries. The analysis shows that more than a quarter of countries have introduced subsidies investigated associated with an increase in fuel prices, a fifth has reduced some taxes. In response to increasing food prices, more than half the countries have introduced subsidies and about 1 / 5 has reduced taxes. The exporting country have used a combination of fiscal and regulatory measures, which are reflected in the increase of export taxes, the introduction of quotas for exports, and some have introduced a ban on exports of certain products. The total fiscal cost of these measures was significant, and at the level of the world amounted to about 0.7% of GDP during 2007-08. year. For a quarter of the countries of this cost was above 1% of GDP. More detailed look, World Economic Outlook - Financial Stress, Downturns, and Recoveries, International Monetary Fund, October 2008, pp. 103 and 104.

calling for the state interventions on the U.S. and Europe's financial markets. Liquidity decline, acquisition, nationalization and liquidation of financial institutions have brought anxiety, fear and the lack of confidence in liquid, solvent and healthy financial institutions. The general uncertainty, and care for "tomorrow" and negative expectations, mixed with increasingly expensive and unavailable money, generated a sharp decline in demand for consumer goods causing inventories piling up, decrease in prices, losses and bankruptcy of companies in the real sector. The adaptation to the new conditions required the decrease in production, dismissal of workers, lower investments which along with the need for increased social expenditures, was leading to the lower budgetary revenues and extremely negative governments fiscal balances.

For a long time, many believed that the financial crisis will have the "decoupling" effect, and that the emerging markets whose financial institutions are not buying "toxic" securities will not be significantly affected by the crisis. Today, it is clear that these countries were the ones particularly affected by the crisis, including the economic growth deceleration percentage, reduction in capital inflows⁹⁸ and the loss of jobs.

The crisis in the Central and Eastern Europe became the classic emerging markets crises same as the one that erupted in Asia in 1997, and Argentina 2000. The crisis has paralyzed the previous credit boom and high private capital inflow, weakening confidence, linked with the negative historical experience of bank failures, leading to the sudden and panic withdrawal of deposits.

The collapse of raw materials prices for certain countries, for Ukraine meant double digit GDP reduction. This in turn increased the value of risky investments of Western European banking groups, deepening the problems of their balances, exceeding the possibilities of national governments interventions. The European politicians are not only faced with the problem of maintaining the liquidity and rescuing economies, but also with the threat of a common currency - the Euro and united Europe.

⁹⁸ The World Bank has forecasted that the net private capital inflow towards the emerging markets in 2009, will probably reach the half of the record of \$1 trillion generated in 2007. The Institute of International Finance has published a more pessimistic forecasts based on which the private capital flows in the emerging markets in 2009 will decline by triple compared to 2008, or by over 80% compared to the record 2007. The largest decline is attributed to the decline in net income based on bank loans. Therefore, it is estimated that the European emerging market region being the most dependable on external banking financing will be most affected. The biggest fall is attributed to the decline in net income on the basis of bank loans. the escape of the private capital means that the emerging markets will face with the lack of funding.

In few months, the crises of one small financial market segment originating in one (most powerful) economy has spread out to all open economies and all economic, social and political life segments.

The first reaction of the U.S. and Great Britain's decision makers to the crises, was to inject additional liquidity in financial markets⁹⁹. The objective was to halt the downturn of the large industrial institutions. The decline in reference interest rates was followed by the approval of government's large rescuing packages. The Europe has reacted similarly, although the European Central Bank has for long hesitated to decrease the interest rates, due to inflation fear¹⁰⁰.

Emerging markets were generally under the impression that the crises is local and individual, linked with bad investments in financial derivatives, and that their economies will be immune to the crises, and up to the last quarter of 2008 they were concerned with the inflation pressure. After it became clear to everyone that the crises will be of global scale and that states which took part in the international exchange of goods, services and capital will not be spared, it led to more extensive coordination and comprehensive joint action. The six biggest Central Banks have opted to decrease their official interest rates and to inject \$4 trillion of direct financial aid and guarantees aimed at unfreezing the credit market and money, as well as recapitalization of unhealthy financial institutions.

All governments actions have failed in assisting to the greater extent. Following the initial encouragements¹⁰¹, the confidence in accelerated switch in trends and the restoration of trust was soon rejected by the market. The real estate prices and shares have continued to fall, stock exchange industrial products such as aluminum, steel and oil have reached their lowest levels in the history, and the global trade was sharply decelerated. The unemployment rose day by day, both in developed and emerging markets, such as China and India. Developing countries were especially hit by the halt in foreign investments, i.e. "escape capital" leading to huge exchange rates fluctuations and fiscal positions endangerment.

⁹⁹ According to some analysts, the action of decision – makers was neither undertaken in a timely manner nor well designed. As an example is cited the "switch in opinion" related to the use of financial rescuing package to the U.S. economy in the amount of \$700 billion – through the rescue fund by recapitalizing banks to the purchase of bad assets, popularly called poison assets.

¹⁰⁰ This hesitation is being justified by different goals of the Federal Reserves and the ECB. And while the basic goal of the U.S. Federal Reserve is to accelerate the economic growth and to decrease unemployment, the basic goal of the ECB is to control inflation.

¹⁰¹ British Prime Minister Gordon Braun, in mid October at the meeting with the Eurozone leader countries, has argued that the model of massive pumping of the state money into the financial sector, aimed at saving the banks from the collapse, is providing results. However, the fourth quarter has brought more sharp fall of 1,5% (previously in third quarter the recorded fall was 0,6%), thus the Great Britain was officially in recession for the first time after 1991.

Pessimistic forecast soon became too optimistic. The IMF's world growth forecasts for 2009, from November 2008, in the amount of 1.75% in January was revised to 0,5%. In March 2009, the IMF has additionally revised the forecast and announced that in 2009, for the first time after 60 years of growth the global recession will be recorded ranging from -0.5 and -1%.

The IMF's expects that the deficit in rich counties in 2009, will reach 7% of GDP respectively, which is huge increase in comparison to 2% of GDP in 2007. Public debt growth forecasts are even more pessimistic, forecasted above 15 -20% of GDP by the end of 2009, compared to only two years before. For emerging economies, indicators are also negative. It is expected that the emerging markets from the budgetary surplus which they have generated in 2007 will switch to the zone of the budgetary deficit at the average of 3% of GDP. To summarize, the state debt at the global lever will record its fastest growth since the Second World War.

Bad financial indicators mean weak credit rating and expensive funding, creating adverse budgetary effects. The price of collateral for state borrowing has increased sharply in last months, which indicates that the investors are concerned with the increased risk in the ability of governments in servicing. Simultaneously, the *spread*¹⁰² between the countries is increasing, even within the Eurozone. *Spread* in term of 10 years of the public debt of Greece, Ireland, Portugal and Spain versus Germany have spread sharply. Thus, Greece as the Eurozone member at the beginning of 2009, had to pay 5,6% for ten – years debt, i.e. by 2,5% higher than Germany.

Fearing that the worst is still ahead, creative and imaginative (macro)economists are formulating new measures and instruments to combat the crisis, and politicians are often randomly accepting them in order to avoid the possibility of being accused of not taking enough action. Since the biggest part of monetary instruments is exhausted by the international institutions, it is required that the governments undertake more coordinated and strict fiscal action. It is suggested that the fiscal response must be "significant, strategic and sustainable"¹⁰³. The "New Deal" is being advocated without hesitations. Its sending the message that in the absence of serious fiscal incentives, the crisis will last longer and the recession will be more severe.

¹⁰² Loan or bonds spread is the difference between different investments in relation to their quality, or risks.

¹⁰³ „Massive, globally coordinated fiscal stimulus is needed: going from the drawing board to swift action“, UN-DESA Policy Brief No.11, United Nations Department of Economic and Social Affairs, January 2009.

According to conservative proposal, the amount of the fiscal stimulus should range between 1% and 3% of the world's GDP. The growing consensus is that this incentive should be higher, especially in economies with extremely low levels of consumer and business confidence. Governments are encouraged to increase their spending at minimum by 30% in order to generate positive multiplicative effects. The IMF and the UN are leaders in addressing these encouragements. The IMF's President Dominique Strauss Kahn is warning: "If there has ever been a time in modern economic history when fiscal policy and a fiscal stimulus should be used, it's now".

Governments are suggested to direct their spending to investments in infrastructure, renewable energy and energy efficiency, in order to provide for the interrelation with the anti global warming measures. With the objective of minimizing the risk, primarily in the fiscal deficit and public debt, they are proposing the adoption of a sustainable mid-term fiscal framework, that will forecast future tax increase¹⁰⁴.

Large fiscal rescuing packages are ready in many countries, starting from the EU and U.S. In December 2008, the European Council of Ministers has adopted the fiscal assistance package worth EUR 200 billion. The U.S. Congress on 11th February 2009, after a huge debate and wrangling, has adopted a compromise law on additional financial stimulus worth \$ 789 billion¹⁰⁵. Non – recurring increase in public spending in the U.S. may be measured only with the one that was generated during the Great Depression. While after the Second World War, the U.S. Federal Government spent around 20% of GDP, in 2009 planned spending is at 28% of GDP, and the budgetary deficit will reach unforeseen 12,7% of GDP, i.e. approximate amount of collected revenues. This is the highest peacetime deficit in recorded history of the U.S., exceeding the federal budget in 2000)¹⁰⁶.

¹⁰⁴ See: „Massive, globally coordinated fiscal stimulus is needed: going from the drawing board to swift action“, UN-DESA Policy Brief No.11, United Nations Department of Economic and Social Affairs, January 2009 and “Fiscal Policy for the Crisis”, IMF Staff Position Note, December 29, 2008.

¹⁰⁵ Immediately upon adopting the new assistance package, the shares market Immediately after the adoption of the new package to help the stock market plunged again as many interpreted as a lack of confidence in the measures adopted.

¹⁰⁶ In parallel with call for the fiscal action, protectionist demands are prevailing. The current British Prime Minister, in his statement in 2007 "British jobs to the British" sent the burning fiery arrow. The British politicians and regulators, "recommended" to the banks that have received a piece of the tax cake, not to lend it outside the house. Aforementioned policy was implemented by other decision makers in developed European countries, particularly France. By regulating and interpreting this policy, even the Switzerland has opted for the domestic borrowing, all under the banner of protecting domestic industry and domestic jobs. The bigger the spreading and growing of the crisis, the bigger is the protectionist fiery element, requests and specific action. One million French workers marched on 29th January the streets of Paris demanding the protection of jobs and salaries. The British workers in the Lindsey refinery owned by the French Total strike because of the presence of Italian workers

Is the discretion fiscal policy the answer to the economic crises?

There is a long lasting open debate on the fiscal policy role in the period of excessive business cycles, especially during the fall in economic activity. The consensus of opinion has not been reached as it is the case with the most other (economic) issues. Interventionists are advocating that the fiscal policy, if wisely carried out, may assist the economy, especially if the problems are associated to the "market error". They are advocating that the fiscal measures are becoming extremely important when monetary mechanisms are exhausted. The state interventionist opponents are advocating that the fiscal instruments, at its best, are useless, and the intervention is deteriorating conditions, causing long - term negative consequences. They are explaining that these measures, apart from generating market distortion, are greatly failing to correspond to the needs (may not be implemented in a timely manner to counteract or to mitigate the negative trends, often having pro-cycling effects, affecting the market only when it redirects - "reaches the bottom"). Furthermore, the fiscal instruments are usually exposed to the influence of the interest groups, thus the additional budgetary spending and the tax burden decrease often take the feature of lavishness.

"Keynesian" argue that the personal spending and investments are dependant on current revenues, and the economic activity is significantly affected by the fiscal policy. Simultaneously, the fiscal policy impact is much weaker in open economies with free capital flows where the fiscal stimulus may "flow - out". In accordance with the crowding -out¹⁰⁷ standards arguments, the vast number of neoclassic theories is emphasizing the expectations role with regard to the future taxation and projections of available income, explaining that the fiscal multiplier is low because the individuals and the companies in considering their future, will pass decisions pursuant to the current spending.

engaged in the extension of the refinery. The Italian company that performed work on the reconstruction of the refinery, has transferred several hundred of its workers in Italy. Panicked British workers, worried for their job or their higher labor cost, organized the strike, after which the company Total has decided to employ British workers. The opposition leader in Parliament strongly reacted to the Brown's statement that the obligations towards the EU partners must be adhered to. The announcement from the U.S. added oil to the fire or to the so called economic patriotism, that Obama's stimulus fiscal plan will be consumed in America, i.e. that is those funds will not be used for purchasing materials for the public works planned by Obama's administration. Many governments have publicly or secretly „advised“ the banks to be „cautious“ in reference to the transfer of funds allocated by the state to the branch offices in other countries. Financers are encouraged to support domestic companies, companies to employ residents and citizens to buy local products..

¹⁰⁷ So called squeezing effect, which implies that increased government borrowing on the market leads to redistribution of funds from the private sector, i.e. reducing the amount of available money for the private sector and increasing the interest rates.

The World Economic Crisis has deepened the discussion on the fiscal policy impact as a contra – cyclic measure. The basis of the modern literature is that the fiscal policy can work in two ways¹⁰⁸. One way is through automatic stabilizers, which arise from parts of the fiscal system that naturally vary with changes in economic activity—for example, as output falls, tax revenues also fall and unemployment payments rise. Discretionary fiscal policy, on the other hand, involves active changes in policies that relate to taxation, subsidies, transfers, social contributions, etc. since the automatic stabilizers influence is limited, the attention at the time of economic crises is focused on discretionary fiscal policy.

The IMF in its “Fiscal Policy for the Crisis”¹⁰⁹ made the reference to the vast fiscal response at the global level. According to the IMF, the optimal fiscal package should be timely, because the need for action is immediate; large, because the current and expected decrease in private demand is exceptionally large; lasting because the downturn will last for some time; diversified because of the unusual degree of uncertainty associated with any single measure; contingent, because the need to reduce the perceived probability of another “Great Depression” requires a commitment to do more, if needed; collective, since each country that has fiscal space should contribute; and sustainable, so as not to lead to a debt explosion and adverse reactions of financial markets.

The IMF is recommending that the least what the governments can do is not to delay or reject current spending programmes due to the lack of funding. Governments are recommended to continue with the investment projects, especially one with “long – run justification” such as for environmental protection purposes, and are especially encouraged to take a larger share in the private – public partnership projects that would otherwise be delayed or unimplemented due to the lack of private capital. At the same time, they are proposing the support to troubled industries hit by the crises.

The recommendation is that the public sector wage increases should be avoided as they are not well targeted, difficult to reverse, and similar to transfers to individuals. However, the IMF is stressing that a temporary increase in public sector employment associated with some of new programs and policies may be needed.

¹⁰⁸ See for details: World Economic Outlook - Financial Stress, Downturns, and Recoveries, International Monetary Fund, October 2008, Chapter 5 - Fiscal Policy as a Countercyclical Tool, pages 159-195.

¹⁰⁹ Antonio Spilimbergo, Steve Symansky, Olivier Blanchard, and Carlo Cottarelli, “Fiscal Policy for the Crisis”, IMF Staff Position Note, December 29, 2008.

By considering the fiscal package, in current circumstances, according to the IMF's recommendations, the increase in spending and targeted tax cuts and transfer has the highest multiplier. Generally the taxes or subsidies cuts, both for the consumers and the companies have smaller multiplier. The IMF's is emphasizing that in theory, public spending on goods and services has larger multiplier effects and, most important in the current circumstances, its first round effects are more certain than those related to transfers or tax cuts.

In order to avoid the public debt medium-term unsustainability, and to prevent the long term negative consequences of measures, it is suggested that they are structured so as to: increase in expenditures and / or decrease in income is temporary subjected to later abolition without encountering major "cost"; to increase the effects of automatic stabilizers, implementation of policies that eliminate distortion; to introduce fiscal medium – term fiscal framework that would cover 4-5 years, to improve expenditures and public debt management, etc.

It is interesting that the IMF's recommendations are not corresponding to the findings of their own study. The World Economic Outlook from 2008, the IMF¹¹⁰, among other things, focuses on the following questions: should the fiscal policy be used as an instrument of struggle with the business cycles, especially in situations of declining economic activity? Whether the discretionary fiscal policy can successfully stimulate the economic activity or it can harm it? The general conclusion arising from the findings of this study is that the discretionary fiscal policy is not successfully stimulating the economic activity in time of the crisis. Positive effects of fiscal stimulus, if any, are modest, being more visible and pronounced in economically developed countries against the emerging markets effects.

The IMF's study includes 21 developed and 20 emerging markets, and covers the period 1970 - 2007. The research covers the period of economic deceleration, and subject to analysis were the situation in which a state did not react by the discretionary fiscal policy and situation in which the state reacted by the discretionary fiscal policy, on the side of revenues and/or expenditures.

Conclusions of this study are as follows. Generally, growth rates are higher in situations without the fiscal stimulus. In situations in which the fiscal stimulus was implemented, better performances were recorded by the states that directed their discretionary fiscal policy to tax cuts than those states directing the fiscal stimulus to the increase in expenditures. The first ones recorded faster recovery and higher growth rates in years after the crisis. The increase in expenditure has led to the

¹¹⁰ World Economic Outlook - Financial Stress, Downturns, and Recoveries, International Monetary Fund, October 2008.

negative effects in emerging markets after three years, mostly due to the fact that once implemented expenditures increase policy is difficult to change later on. For developed economies, the expenditure increase policy is moderately countercyclical. A stimulus based on tax cuts has proven to be more efficient in increasing the economic activity than the increase in expenditures, especially in the emerging markets.

The impact of the negative fiscal deficit and increased state debt on a long-term growth, was documented by numerous empirical studies. The impact fiscal deficit impact assessment to the economic growth was made by the World Bank¹¹¹, for Eastern Europe and Central Asia (ECA). The Assessment is indicating that the fiscal deficit increases the instability of business environment, generating negative impact on investment climate, which is particularly sensitive when the ECA countries are, exposed to strong globalization forces and when they are trying to attract domestic and foreign investments. The economic instability in the ECA countries has been for years ranked as the top business threat. At the same time, the econometric analysis is reaffirming that the lower fiscal deficit is ensuring higher growth. The World Bank Study is indicating the analysis showing that the fiscal balance improvement by 1 percentage point of GDP leads to the increase in GDP growth rate at the average by 0.4 to 0.5 percentage points or cumulatively reaches 4.6 percentage points of GDP for ten years.

The question to be posed is, why most states fiscally intervene if the experience and relevant researches are suggesting that such intervention is inefficient? The answer can be found in: the fear of not undertaking actions when there is a pressure and expectation to undertaken; tendency of politicians to redistribute and manage, increasing their powers and influence; environment for intervention created by the international organization through their recommendations, cries and criticism to the state to help as much and as soon as possible; as well as due to the methods copied from the big developed countries that were first in introducing the interventionism.

Furthermore, the question may be posed that if the states are fiscally intervening, why they fail to do it in a more efficient and sustainable manner such as the tax and spending cuts, and it is commonly the opposite? Even here, a part of explanation interrelates with the public and international institution's pressures, coping effects, but more importantly in the tendency of politicians to (over) spend, to present them and to leave a mark with their actions. Tax cuts are always less visible and for an average voter is more acceptable than the bridge construction, road paving and repair or direct social and other budgetary benefits. Increase in spending is often generally acceptable by the majority of voters (citizens), and its cuts become the burning issue

¹¹¹ The World Bank, Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia, 2007.

when it induced fall in salaries and pensions, being socially and politically problematic.

Conclusion

Politicians are in hunger for public spending. Despite experienced and affirmed negotiations of this policy benefits, the appetite is increasing at the times of the crises. The dangerous faith in the omnipotence of the state and effectiveness of its interventions is not fading away. Just recently, Milton Friedman has claimed that the world has adopted the concept of freedom, and that the socialism which traditionally implies the state ownership and production means management can not be repeated. It seems that he was not farsighted. The history is repeating.

The increase in unemployment and problems in companies are generating pressure for providing greater social contributions and subsidies. Individuals and interest groups are using the crises as an excuse for justifying their failures and the opportunity to realize personal benefits at the expense of taxpayers and under the general interest slogan. Multilateral institutions are using the opportunity for repositioning, and macroeconomists for expressing their own creativity. They all agree in requirement for state support and assistance. Thus the current global economic crisis has brought the new global pressure for the state intervention. The new protectionism demands wave has risen. Nationalization and the support to private companies are policies implemented by the richest states whose pillars of developments were economic freedoms, market economy and private property.

States are competing in the bounty of its measures aimed at rescuing the economy. Fiscal packages, aimed at protecting spending, production and employment, are considered last resort. Billions of Euros and U.S. Dollars were as oil sprinkled to the fire. It was empirically experienced that the economy stimulus through the greater budgetary spending is just generating higher public debt, and funds are often used by the decision makers for the support of preferred individual projects and to meet the needs of the interest groups. Even qualitatively designed and efficiently implemented fiscal stimulus represent irreversible increase government spending, which in the long run hampers the growth and the development. Simultaneously, the fiscal stimulus can not allow market selection of healthy and sick of business entities. Some are artificially maintained in life, and the other are suffocating and pushing down possible healthy growth and development. Subsequently, all chances in the long run are reduced to a vicious circle of state redistribution. The best illustration to this is the experience of Japan, which for decades is losing the battle to revive the economy though the state intervention, and the constant result is stagnation and growth of public debt.

Required fiscal answer at the time of the economic crises corresponds to the one at the time of the economic prosperity – decrease in taxes and decrease in public spending. Almost all rich countries of the world, all transitional and fast-growing economies are spending significantly above the measure for healthy, sustainable and long term economic growth. By intensifying spending, the state not only spent excessively, but it created the feeling and the environment that this is possible and desirable in the private sector. The mass of unrealistic expectations has shattered, suddenly and unexpectedly as it usually happens. The economic prosperity may not be built on scattered pieces. It is necessary to return to old and proven recipes, and not to repeat sinful policies in recent past that proved to be wrong.

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OLD - NEW CAPITALISM

Abstract: *Existing markets are exhausted! Business is seeking for another chances and possibilities in order to increase its profits, under the cloak called 'creative capitalism'. Successful companies are trying to promote a new idea and need for improving existing concept of capitalism, covered with 'social responsibility' of business. They are emphasizing that profit maximization is not the only goal. Other, not less important goal is addressed to altruism and charity in order to solve existing problems of social inequality and poverty in the world. Is it a real true?! Does profit maximization by itself gives new chance and have positive influence on society? Is creative capitalism a new theory hidden under altruism and philanthropy with not so 'altruistic' goals? There's a business chance to expand on new markets (focusing on poor economies) and after some time create a new customer of their products and cheap source of labor force, as well. Poverty brings profit in creative capitalism! On the other side, is 'corporate social responsibility' reasonable at all?*

Key words: *creative capitalism, free market, philanthropy, corporate social responsibility*

Resume: *Der jetzige Markt ist ausgegeben! Die neuen Chancen und neuen Möglichkeiten für die Verwirklichung des Profits und zwar unter der Maske der neuen Definition des Kapitalismus noch "kreative Kapitalismus" genannt, werden gesucht. Erfolgreiche Unternehmen versuchen unter dem Deckmantel "soziale Verantwortung von Unternehmen" die neue Idee zu fördern und die Notwendigkeit nach dem Aufbau des bestehenden Konzepts des Kapitalismus darauf hinweisend, dass es nicht das einzige Ziel der Gewinnmaximierung ist, sondern auch das Schaffen der Vorteile für alle. Ist es aber so? Bietet die Gewinnmaximierung allein nicht eine neue Chance und macht es auf diese Art und Weise sogennantes Nutzen der Gesellschaft?. Ist das kreative Kapitalismus nicht tatsächlich eine neue Theorie, die dem Unternehmen passt, dass unter dem Schleier der Gutmachung und dem Altruismus, mit dem Ziel der Verringerung der Armut, zuerst die neue Märkte in Kraft zu setzen (sich auf die armen Länder richtend) und später auf diese Weise den neuen Kunden seines Produkts zu schaffen, aber auch eine billige Quelle von Arbeitskräften. Etwas wie die Spinne, die zuerst die Aufmerksamkeit auf sich richtet und seine Opfer lähmt, und erst danach sie isst? Die Armut bringt den Profit! Besteht auf der anderen Seite überhaupt die Entschuldigung "des sozialen Verantwortung des Unternehmens", dass sie sich verpflichtet auf ein Teil des Profits zu verzichten, damit weniger Ungleichheiten in der Welt gibt? Wessen Profit ist es und ob die Unternehmen auf diese Art und Weise überlegen können?*

Schlusselwörter: *Keatives Kapitalismus, Markt, Philantrophie, soziale Verantwortung*

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Резюме: *Существующий рынок уже уходит! Надо искать новые шансы и новые возможности приобретения прибыли, причем под видом нового определения капитализма под названием «креативный капитализм». Успешные компании пытаются под видом «общественной ответственности компании» пропагандировать новые идеи, а также и необходимость модернизации существующей концепции капитализма, указывая, что это не единственная цель максимизации прибыли, но и создание благополучия для всех. Это правда? Разве самая максимизация прибыли не дает новый шанс на создание благополучия в обществе? Разве нельзя сказать, что креативный капитализм, на самом деле, новая теория, которая способствует бизнесу, под видом альтруизма, с целью уменьшить уровень бедности, сначала создать новые рынки (с упором на бедные страны) и тем самым позднее создать нового покупателя своего продукта, но и дешевый источник рабочей силы. Что-то вроде паука, который сначала парализует свою жертву, а только через некоторое время съест ее. Нищета приносит прибыль! С другой стороны, существует ли вообще основание «общественной ответственности компании» обязаться, из-за уменьшения неравенства в мире, отказаться от части прибыли? Чья эта прибыль и могут ли компании так «думать»?*

INTRODUCTION

Does creative capitalism represent tendency which will reshape existing concept of capitalism primary established on profit into a new concept based on social responsibility of companies? Is idea of creative capitalism derived spontaneously or it is a trend which follows existing changes on global markets, global crisis like a paradigm which is trying to adapt to that new situation? Is it a sign that capitalism itself is got into a crisis because of the sign which shows that its new promoters reminds on collectivistic approach in life and business, or socialism? Is it a crisis of individualism? Or time dimensions of these crisis held accidentally or purposely at the same time? How business or company can be social responsible? Promoters of this idea often mention moral values. Is it, contrary, idea of social responsibility mission impossible in case of companies, in environment such as free market is? Isn't it nice to hear that 2% of companies' profit goes to help poverty problems in China? But, does corporation like a legal entity has a right for such actions? Whose profit is used? Does corporation have its own shareholders or employees? Does this concept have negative influence on concept of open market and individual freedom? Why such corporation resigns of that part of profit in order to improve equality on a global level? Interest can be recognized as one of the answers. On the other side, it seems those corporations are spending someone's money for the purposes of general interest of society. Concerning that fact, what is the difference between state and business?

Nevertheless personally follower of Friedman's definition of social responsibility, this text gives relatively new idea of creative capitalism and term of social responsibility in companies.

CREATIVE CAPITALISM

Nevertheless capitalism as a system represents strict rules and procedures it is also based on spontaneity and self-regulated concept of open market. It represents a concept which derived from human nature and is based on spontaneity in order to achieve profit maximization.

Even before idea of creative capitalism is born, concept of social responsibility of companies already existed. Concept of social responsibility of companies has its two bases. The first one has defined 'shareholder's rights'. The other one have been addressed to the argument that corporations are not just responsible for its shareholders but the society as a whole. *What is creative capitalism? Is Bill Gate's idea about creative capitalism really needed to improve existing concept of capitalism in 21st century?* According to him, existing concept of capitalism needs to be improved and there's a need to create a system which will contribute decreasing of inequalities and poverty in the world and which will solve some problems that cannot be solved by governments or corporations.

Personal interest and profit are key drivers of the capitalism. On the other side, creative capitalism is based on 'recognition' (affirmation, achievement) which represents a replacement for personal interest. Concept of recognition, according the creative capitalism, does not represent a profit as a key goal, but it points out affirmation and company's achievement as well as its efforts to increase overall public prosperity. Is recognition or affirmation current alternative to individual interest or it is a new way how to get to it? According to this concept, companies are obliged to take one part of their profit for general public prosperity and to promote themselves on less developed markets, in order to introduce that market with their products.

This principle is often criticized and points out following question – *If we consider a need for affirmation and promotion as a natural need which each individual has inside, why that principle was not discovered five centuries ago?* The main principle of this concept is that companies are not just responsible for their employees-shareholders but for the whole society as well. On the other side, a key opposite question to this is – why don't we let companies to spontaneously do their job on the market which will spontaneously improve society as a whole, without any previously defined tasks and obligations. Only by that way, business cannot be defined as a state and its role in society.

GATES'S 'YES'

Concept of creative capitalism is based on idea of differences in economic development, poverty and education in the world as well as the fact that government programs and philanthropy cannot solve existing problems and make some significant changes. Followers of this idea have opinion that only capitalism can solve this question but they do not explain why private sector needs to be in charge to solve these problems. .

Gates suggests set of ideas for further implementation of creative capitalism, such as:

- Simple corporative philanthropy – corporations need to invest one part of their profit and to allocate it to those individuals who need it.
- Companies need to turn more to less developed markets.
- Price adjustment: to have two different prices for each product, according the level of economic development in targeted country-market.
- Governments need to stimulate companies to help to solve poverty problems in less economically developed countries in the world.

Gates is using the idea of free market and capitalism to create new business opportunities which will bring benefit for much larger part of population, not just to its owners. According to him, creative capitalism today is present as a defined system. Most world corporations have recognized an importance of new markets and less developed countries. On the other side, creative capitalism does not represent a new theory. And it is not opposite of current definition of capitalism. It is a way which can give an answer on a key question – How to spread benefits which brings capitalism and increase quality of life?

Creative capitalism is not the answer on short-term and long-term successes and failures in economy. It was derived from the fact that historically human civilization does not have required quality of life. A key challenge is to overcome existing differences in wealth and poverty as well as education, on a global level. Capitalism created different positive achievements: better quality of life, economic freedom as well as free speech. Today, capitalism is faced with the problem how to enable this progress to all. Because of that, creative capitalism is analyzing this issue, such as increasing of innovations and creating better business environment in less economically developed countries which represents a new chance for new markets.

Example: Creative capitalism in Kenya

Here's an example with mobile phones. Several decades ago companies were underestimated these markets, but today they have substantially emerged. In 2000 Vodafone bought package of shares in Kenyan mobile phone company presuming that Kenyan market has maximum of 400,000 users. Today, that company (Safaricom) has more than 10 million users. Company was successful because it creatively motivated lower levels of Kenyan society to start to use mobile phones. Their users preferred more to pay calls per second but per minute, which decreased their costs. Safaricom makes profit as well as makes differences. Today, farmers are using their mobile phones to find the best prices for their products on the market. Number of functions and mobile phone services is increased. Today, many Kenyans are using their mobile phones for electronic payments and money transfer.

Besides the fact that companies should try to find new markets they will also adjust their business to less wealthy population-they will offer their products with reduced prices to larger group of customers. Industries, such software or pharmaceutical companies are, have very low production costs and because of that they can sell more expensive products to well developed countries and at the same time products with reduced prices to less developed countries. Other companies from other areas cannot 'play' with their prices on this way, but they can get a reputation and motivate those lower paid customers. The other benefit that companies can achieve is available employees because of the fact of high unemployment rate in less economically developed countries. This is especially related to young generations and possibilities that are in front of them.

Creative capitalism represents a hybrid form of joint individual interest and altruism which serves to the whole population. *Is that system sustainable? Does utility join together these two antagonisms?* According to Gates geniality of capitalism is defined through its ability to convert individual interest to the interest of the whole population. System leaded by an individual interest is based on innovations which improved million people lives.

According to him there are two basic principles of human nature: self interest and altruism. The main challenge is to create a system in which market motivation, including profit and company affirmation, motivate changes. It is a basic principle of a creative capitalism in which governments, business and NGO sector join their efforts to decrease inequality in the world. The main role of governments is to define policy and funds to help less developed countries on that way in which they will develop business environment and decrease level of poverty.

For example, during past several years, Microsoft has developed corporative philanthropy as a way to introduce their technology to those people and countries that have difficulties to have an access to that. Microsoft has donated 3 billion dollars in cash and software in order to solve digital divide problem. On the other

side, their main contribution is not just seen through free software donations but through showing a way how to use different technologies that can be useful to people and countries. They are developing wireless technologies in order to avoid extra costs of introducing new ways of Internet connections in rural parts of economically undeveloped countries. In these examples Gates sees specific implementation of creative capitalism.

FRIEDMAN'S 'AGAINST'

Gates is not the first one who is analyzing issues related to social responsibility of companies which is present through Milton Friedman's critics of this idea, in '70ies. Social responsibility of business in ambience of free open market is defined as 'mission impossible'. According to Friedman, business owners are defending free market when they claim that business is not just based on profit but has some segments of social policy, as well. Friedman shows that promoters of this idea are just proclaiming socialism and directly destroy idea of free market and society.

'Discussions about social responsibility of corporations has lack of analysis and precision. What does it means if business has some sort of responsibilities? Only men-individual has its own responsibilities. Company, as an artificial creation has its artificial responsibilities in comparison with an individual. In order to define this issue the first task is to define to what and to whom is related some sort of responsibility. Business owners are responsible individuals, nevertheless if they are managers or owners. In open system chief executive officer is defined as employee in company. He has direct responsibility to his employees. Responsibility is defined in business activity in correlation with ideas and desires of business owner in order to gain a profit. On the other side, CEO is a person with its personal rights. As an individual, he has other responsibilities (family, consciences, religion, club, country...). As an individual, he can personally decide to invest some of his income for charity, for example. This sort of voluntary investing of money for these purposes is correct and represents an example of social responsibility. He's spending his own money for these purposes. On the other die, company cannot be social responsible and invest part of its profit for some 'socially responsible' purposes because of the presence of its shareholders. It means that in that case principle of voluntarism and free decision making are endangered and are in a contrary of basic principles of open society and free market. 'I'm impressed with schizophrenic attitude of our businessman. They are able to be extremely clever and intuitive if we consider intern processes of their business. On the other side, they are not so clever if we consider things and issues out of their business and which has long term consequences for their business, as well. Their lack of intuition is presented through price control system, income policy or definition of social responsibility. That approach can bring only short-term glory'.

(Milton Friedman, 'The social responsibility of business', New York Times, 1970)

Using social responsibility, according to Friedman, as a mask is not good approach and it is threaten idea of free and open market. Social responsibility doctrine is not

too far from explicit doctrines of collectivism. According to Friedman there's one natural side of social responsibility in business – to use their resources and be included in activities that should directly increase profit in free market environment in conditions of open competition.

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Danijela Laketić

GLOBAL ECONOMIC CRISIS – A PROBLEM BUT ALSO AN OPPORTUNITY!

Abstract: *Think recession is a bad time to start a company? The founders of several major corporations in the world had thought that they had a great opportunity and they were right. Recession might be pinching businesses badly, but some corporate giants, like P&G, GE, IBM were born in the time of economic turbulence. Companies born during downturns are a good example that the world should see the economic crisis as an incredible opportunity. The current economic crisis is calling into question business model fundamentals and putting all companies under stress. Volatility and uncertainty are the foremost characteristics of the new world economy and may well be for quite a while to come. Yet, experience of previous recessions shows that there will be companies that continue to prosper. So, we should not just look at the economic crisis only as a problem. It is a possibility to rebuild the economy, rebuild our concept and rebuild our way of thinking and doing things in order to move in the right direction with the right structure, because the current structure will create problems of the type that is already created. Take piece by piece and rebuild, redesign, so that we can go on.*

Key words: *opportunity, recession, crisis, problems, incredible, stress, volatility, uncertainty, prosper, born, rebuild, redesign.*

Resumee: *Denken sie dass die Zeit der Rezession eine schlechte Zeit zum Einrichten eines Unternehmens ist? Die Gründer von mehreren großen Unternehmen in der Welt denken dass sie eine große Chance bekamen, und sie hatten Recht. Die Rezession kann einen schlechten Einfluss auf die Wirtschaft haben, aber einige Konzerngigante wie P&G, GE, IBM waren zum Zeitpunkt der wirtschaftlichen Turbulenzen, geboren. Im Herbst Trend gegründete Unternehmen sind ein gutes Beispiel dafür, dass die Welt die wirtschaftliche Krise als eine unglaublich gute Chance sehen muss.*

Die aktuelle Wirtschaftskrise wirft die Frage auf Basis von Business – Modellen und setzt alle Unternehmen unter Druck. Instabilität und Unsicherheit sind die Hauptmerkmale der Weltwirtschaft und es kann bis zur Erscheinung noch dauern. Die bisherigen Erfahrungen zeigen, dass es in der Zeit der Rezession auch Unternehmen gibt, die Fortschritte und Progress, machen. Daher sollen wir auch nicht die Wirtschaftskrise nur als ein Problem betrachten. Dies ist eine Gelegenheit, um erneut beim Aufbau der Wirtschaft, Wiederaufbau unseres Konzeptes und unserer Art zu denken, und die Durchführung in die richtige Richtung mit der richtigen Struktur zu schaffen, da die derzeitige Struktur Probleme erstellt hatte. Nehmen sie ein Stück nach dem anderen, bauen sie wieder auf, ein neuer Design, so dass wir fortsetzen können.

Stichwörter: *Gelegenheit, Rezession, Krise, Probleme, unglaublich, Stress, Instabilität, Unsicherheit, Prosper, einrichten, umbauen, Redesign*

* „DZU Atlas penzija“ - Atlas Group, Podgorica, Montenegro

Резюме: *Думаете, что рецессия плохое время, чтобы учредить компанию? Учредители нескольких больших мировых корпораций думают, что они получили замечательную возможность, и они были правы. Рецессия может плохо влиять на работу, но некоторые корпоративные гиганты, как P&G, GE, IBM, рождены во время экономических потрясений. Компании основаны в течение тренда спада, представляют собой хороший пример того, что мир должен видеть экономический кризис как невероятный шанс.*

Нынешний экономический кризис ставит под вопрос основы деловой модели и оказывает давление на все компании. Нестабильность и ненадежность являются главными характеристиками новой мировой экономики и может еще продлиться пока они не возникнут. Однако, опыт предыдущих рецессий показывает, что будут существовать компании, которые продолжают преуспевать. Соответственно, не надо смотреть на экономический кризис только как на проблему. Это возможность снова создать экономику, снова создать нашу концепцию и образ мышления и осуществления дел, с целью двинуться в правильное направление с правильной структурой, потому что нынешняя структура создаст проблемы уже созданного типа. Возьмите кусок за куском и снова постройте, переработайте, так чтобы мы могли продолжить.

Ключевые слова: *шанс, рецессия, кризис, проблемы, невероятно, стресс, нестабильность, ненадежность, преуспевать, учреждать, снова построить, переработать*

Introduction

In the time of crisis, more and more companies are thinking about cutting costs, and starting one's own companies seems a crazy mission. However, as much as the crisis means cancellation of production on one hand, it also means an opportunity to start a business, on the other. True, for such a move one needs to be wise and thoroughly study the situation on the market. It is interesting to mention that during the economic crisis many famous and successful companies were born, whose founders have recognized the necessity on the market, such as P&G, GE, IBM etc. Many think that the effects of the crisis have only a destructive character, however, I think that such a claim is not entirely true, because the crisis has its positive, constructive effects; e.g. if a company successfully overcomes the crisis, it makes it stronger, and the feeling of one's value grows – a new way of thinking in a crisis situation brings to radical changes.

Financial crises – Financial crises are bound to happen and represent one of cyclic events which hit the world from time to time, with smaller or bigger impact. Once they included parts of the world, and with the widening of the globalization process, as the case is today, almost the entire planet. The problem of origination and development of a crisis is a very complex one, because it contains several elements

which are linked to one another, making it almost impossible to exactly define its starting point and clearly define its end.

By opening young markets and development markets for foreign investments nearly twenty years ago, as well as opening of markets of developed countries for goods from the developing countries, the era of globalization started. The advantages of liberalization of the capital market for the developing countries reflected in their significant capitalization. The globalization made easier and encouraged the communication and flow of information, share of cultures and international democratization. Corporative strategies of big enterprises became transnational, the technology development reached big proportions, and the consumer markets all over the world connected, thereby the leading forces globally achieved higher efficiency and growing wealth. Negative sides of globalization reflected in the vulnerability of national economies related to many problems, big negative influences on the environment, political risks etc.

It is obvious today that the new development paths are being looked for, which is becoming urgent in terms when financial crisis, the hardest globally - synchronized recession in modern economic history, has still not said everything it had. I don't think that it will cause dramatic social problems, but I think that it is the psychology crisis the one that suffocates the economy. The principles of free flow of men, goods and capital, and the democratic achievements as well as the need for world peace can not be and will not be jeopardized. It is needed to do everything in order to regain the trust into the world financial system and from there to seek new constructive solutions.

One of the first financial crisis dates from the beginning of XVIII century and it called the South Sea Bubble, after the English "South Sea Company". The Company was founded in 1771 and the founding securities were divided to creditors that credited England in several previous wars. The Company got the monopole over trade with colonies in the south hemisphere, so, logically, it was expected that the Company would perform business operations successfully, bringing owners high profit, which however did not happen. Thus, the first stock market collapse in history happened, and the trust into the overall financial system was shaken.

In the new history, certainly the most famous stock market crash is the one in the end of the 20-ties and beginning of the 30-ties of the previous century. During the 20-ties, first of all at the NY stock market, but at others in the US as well, the prices of shares and other securities were increasing rapidly. There was big interest in investing in shares, and the majority of investments were on credit. Considering the trend of growth of prices of almost all shares, it was expected that, on the maturity date, everyone would be able to pay the rest of the price of bought shares, since in

that moment they would be able to sell them, generating thus a capital gain. Taking a credit from a broker or a bank for paying the remaining price of shares, the investor pledged as a guarantee the bought shares.

If the prices of shares would increase, they would sell them and pay the credit to the bank with interest, and if the prices would fall, the investors would give up the purchase leaving the shares to the bank to settle the debt by selling them. These speculations brought to the amazing increase of shares prices, far above the real value, which brought to the real speculative stock market boom. When it was understood that the growth of shares had nothing to do with the real economic performances of the companies, what is called today "The Black October" happened.

In October 1929 almost all participants on the financial market were in great losses, including professional investors and experts. When in 1933 the crisis was over, the prices had lost cca. 85% of their value compared to 1929. This collapse made the American president Roosevelt initiate the adoption of numerous laws, which are still valid today, for the purpose of preventing similar events. The Black October was the starting point for the Great Depression, which lasted the next ten years in the US, but which hit the majority of other countries around the world.

Something similar was happening in the US during the last year as well. It was much talked about the crisis of the mortgage market, but few of them could suppose that it would bring to the situation that we witnessed in the last months. It could be said that the root of the problem lies in the very essence of the American consumer society, but also in the constant struggle for profit of American financial corporations. Life on loan, i.e. getting indebted easily, but also the significantly decreased criteria for granting loans to individuals for buying real estates, brought to the rapid increase of real estate prices on the market, which brought to speculative activities by which individuals but also organizations tried to get rich on the enormous increase of real estate prices caused by constant growth of demand. And, step by step, a bubble was created that was already seen before.

Typical for financial crisis is that there is a chain reaction including a line of participants in the financial market. The domino-effect caught investment banks, funds and other participants, which faced a serious jeopardizing of their liquidity. Withdrawal of deposits, impossibility to collect the receivables and general liquidity crisis led to bankruptcy of some of the biggest world players on the financial market. The jeopardized liquidity of the overall financial system led to the decrease of trust in securities, i.e. into the entire financial system, whereby the financial crisis culminated.

The most representative example of the crisis impact today is Iceland, whose banks had debts six times higher than the Iceland's GDP. This state faced bankruptcy due to the too-big financial sector, i.e. worthless securities and is still trying to find a way to heal its financial system.

Related to Montenegro, the financial crisis effects are visible, but I think that the financial crisis in terms of non-liquidity of the banking system will not hit us hard, because our banking system is in its core different from the one in the US and our banks did not mainly invest the funds into doubtful securities on the world market. Also, the restrictive policy of the Montenegrin monetary authorities, by a set of measures passed by the Montenegrin Ministry of Finance and the Government of Montenegro, made the exceeding and critical indebtedting of individuals impossible, so the basic elements of the economic crisis here will not be felt drastically. Still, the general worldly non-liquidity, i.e. the absence of free financial funds brings to a more difficult inflow of direct foreign investments (by which Montenegro was recognized in the recent period as the leader in the region), decreased economic activity, increase of unemployment rate and mistrust.

It is not the same when you have a financial crisis which originates from bad securities and a crisis which is the result of lack of trust and self-confidence that things will go in the positive direction. Luckily, in the case of Montenegro, we are talking about the second option, i.e. we should try to regain the trust in the economy and securities, to return the savings into banks, invest in future through voluntary pension funds – encourage the business activity and show that we can work and live normally.

We have challenges before us, because in the time of crisis it is very important to preserve the overall stability. We must show responsibility and be aware of the weight that the global economic crisis carries in order to avoid the danger of inflicting serious damage to our economy. This is the time for cooperation on the international level, because even though the world economic crisis originated from the US, resolving it demands joint strength of all factors on the global scene.

I think that a better time for reforms can not be waited for. The state of the economy is such that it demands a brave and quick action, in order to create a favorable basis for growth. The key goal of development of economic policy should be reflected not only in the growth rate, but also in the qualitative changes based on, first of all, new technologies and new knowledge, so that we could answer to the demands of the global market.

Era of lower demand, lower liquidity and deeper crisis – Regardless of whether the economic crisis will last two or more years, as estimated by the European

experts, or one year, as optimists believe, it is indisputable that companies must prepare for the era of lower demand, lower liquidity and deeper crisis. Managers of current and future enterprises should insist on maximum savings at all levels, try to negotiate with banks about refinancing loans and acquiring new ones for starting a business activity (even though it is disputable how profitable it would be to enter in such a deal having in mind that financing by banks is getting more and more expensive), and also sale of property which is not in the function of the basic activity should be applied as well. Finally, as an (unpopular) savings measure there is leaving people without work, even though firing employees is the measure number one in Anglo-Saxon system, as well as vacations, social programs etc.

One should focus on priorities, rely on the existing resources and staff, postpone all investments that are not absolutely necessary and urgent, but continue to invest in everything that will keep the sustainable from the competition. If there is no market, production should not be increased, because the stock might mean an additional loss. Especially, it is necessary to lower all costs, the fixed, variable, direct and indirect, and first of all, the administrative ones, and make the rationalization of production processes. Management should be involved in the company's restructuring, because it is important to survive, keep the employees and the market. In one word, be positive, but also honest about the challenges and development expected.

How much a psychological aspect is important we can see from one of many examples – a fashion designer Armani – who stated for the famous fashion magazine Vogue that some of his very faithful clients annulled their orders. He firstly emphasized his line “Prive”, which stopped with sales. He doubts that his clients, who have millions, have financial problems. “That does not mean that they do not have the money. This is about psychology. No one dares to buy. The recession is in its peak and our sector will feel it, from “Zara” to “Cartier”.

Another recipe for recovery might be applied in such a way to negotiate with creditors, banks or other legal entities about conversion of debts into property or capital. In the first case, if you owe someone a million euros and you pay 100.000 euros interest on that, you should think about “closing” that million euros by making your creditor owner of a part of your property for that amount. When converting debt into capital, you should at the same time think about the strategy of coming out, i.e. in which way, when and under which conditions, to sell or repurchase the converted capital.

In order to overcome the crisis easier, one of the measures is selling a part of the company, which is widely applied in the EU countries. If a minor or major share capital should be sold depends on the situation, but it is fact that potential investors prefer to buy majority shares. Apart from the money, they get in that way a serious

strategic or financial partner which will make the company stronger. The sale should be followed by recapitalization which should provide additional funds for further development. It is possible to obtain fresh capital by issuing shares to the existing or new selective investors. True, recapitalization today can also be unsuccessful because the current owners usually expect a considerably higher amount from the price the buyer is ready to pay.

Especially in turbulent times, it is a key issue to update the planning of liquidity on a very short period of time. It is important to plan cash income and expenditures in accordance with their planned frames. It is important to have a vision of the overall development, i.e. to comply the activities in the short and long period of time.

The biggest companies founded during crisis – Initiating one's own business during recession is not always risky, which will be confirmed by the examples of companies originated during the crisis:

Procter & Gamble – the company was founded by the producer of candles William Procter and the producer of soap James Gamble in 1873 in Cincinnati during the big financial crisis in the US and today very well known brands such as Pampers, Oral – B, Panten, Duracell, Tide or Pringles, speak enough about the justifiability of such an action. Considering that consumers always need their products, they represent the leading world company in production and distribution of things needed in every house, thanks to the successful business operations (also) during the time of these financial crises. With income of 12.1 billion dollars in 2008, this company can proudly say that the crisis does not affect it too much.

IBM – this computer giant was founded in the period of the second depression and between 1873 and 1896 by merging of three companies which have been separately involved in development of new technologies in the field of accounting. At the time of that crisis, they merged partially out of financial reasons, but also in order to join potential and increase the competitiveness. The company had a significant breakthrough at the market during the sixties of the last century and since then it has been one of the most significant corporations in the development of new technologies.

Microsoft – during the time of crisis, a significant American producer Microsoft has been founded in 1975 by an ex-Harvard student Bill Gates. Thirty years ago it was just a small company, while today Microsoft generates more than 60 billion of income a year and is grabbing new areas, including VoIP and CRM. The estimation of Bill Gates is that the current global crisis might last even four years and he believes that the new economic growth might be encouraged by innovations in science and technology.

General Electric – a company originated in the US during the big economic crisis at the end of the 19th century which, in time, became a giant in electric devices production. A famous inventor Thomas Edison is the founder of the American Technical Conglomerate General Electric (GE), which started to perform business operations in 1876 during the six-year recession. Mr. Edison created a, at that time, revolutionary bulb and GE from that time evolved from a strong production company to the third biggest company in the world. Today, GE represents one of the leading companies in the world, which is illustrated by the income of 183 billion USD from 2008. However, the current crisis hit them as well, so in the end of the last year the profit fell by 19% and capital investments decreased by 30%. But, the optimism and experience from the times of crisis speak in favor of the bright future of this company.

Hewlett Packard (HP) – during the Big Depression, in 1939 an American technological company Hewlett Packard was founded in a garage of Palo Alto by Bill Hewlett and David Packard. The company, started only with 538 USD, grew into the first technological business activity, whose income exceeded 100 billion USD in 2007.

General Motors – until recently the strongest producer in the automobile industry, GM was founded in 1907. Overcoming successfully all crises to come, it became one of the strongest points of the US economy. However, the big increase of oil prices and a significant decrease of car sale in 2008 brought great losses to the company, so the head persons of GM, at the end of previous year together with Ford and Chrysler, asked from the US Government 34 billion dollars for recovery of production, and they think that by their activities, they can decrease the costs and generate growth in a reasonable period of time.

CNN – a faintly known TV station The Cable Network News, founded during the recession in 1980, today is famous as the CNN. Unavoidable in the news field today, it changed the way in which the viewers receive information thanks to broadcasting news 24 hours a day. CNN is watched today by a billion and a half people world wide.

Hyatt Corporation – the US hotel company opened the door of its first hotel during the recession 1957 – 1958, during the term of office of the US President Dwight Eisenhower. The hotel chain in the following decades became a internationally known and today it has more than 365 hotels in 25 countries.

Burger King – during the recession before the American Burger King was founded, the second largest fast food chain after McDonalds. The company started with business operations in 1954 when James McLamore and David Edgerton opened the

first Burger King restaurant in Miami. During the recession in 1957, the company successfully presented the sandwich Whopper, and today it has restaurants on more than 11.100 locations in 65 countries in the world.

Sports Illustrated – approximately at that time, the American sports magazine Sports Illustrated was started. It was a favorable moment for the magazine because the boom of professional sports started soon after it started being published. Sports Illustrated is now sold weekly in cca three million copies in the US.

IHOP Corporation – in the time of recession in 1957 – 1958, the chain of restaurants of IHOP Corporations was initiated. The first restaurant in the today national chain of IHOP was opened in 1958 in Toluca Lake in California. The owners of the company Al and Jerry Lapin were running this fast-growing company, which started the sale of franchise three years later. IHOP's restaurants today are located in more than 1.300 locations in the US.

Jim Henson Company – a well-known American doll-maker, Jim Henson, named by himself the company he founded during the crisis in 1958. Jim Henson Company is behind some of the most famous doll characters of all times, such as Miss Piggy, Kermit the Frog from the Muppet Show and Elmo from the Sesame Street. Jim Henson Company, which is today run by the founder's children, keeps creating popular children shows and films.

Trader Joe's – the American Trader Joe's started as a chain of stores selling everyday things, named Pronto Markets, and was also founded during the crisis in 1958. Almost a decade later, in 1967, the company changed its name into Trader Joe's and started selling unique things under its own name. Today it has grown into a company with more than 280 shops.

Lexis Nexis – provides information and business solutions in many areas, legal issues, risks management, media. The company, which worked first for the US Government, started with business operations during the oil crisis in 1973 which pushed the USA into the sharp economic decrease. The company has expanded its operations since then into hundreds of countries.

FedEx – this company was founded in 1973 during the oil crisis. The company was founded by Frederick W. Smith, with the aim that all important documents arrive on time to their destinations within two days. The company becomes profitable only after the end of oil crisis in 1975. Today's situation and the crisis in 2008 represent for this company a certain dejavu from their beginning. The company delivered at the beginning 186 packages in 25 towns, and now it delivers more than 7.5 million shipments every day around the world. Lately, the demand for courier services

decreased, so the overall annual turnover in 2008 decreased by 2%. The Management of FedEx therefore announced that they expect that 2009 will be the hardest year in the history of business operations, but that they are aware of it and can deal with the challenge.

The crisis revived old trades as well – A difficult economic crisis, the hardest one since the one from the 30-ies of the last century, made many citizens to come back to some already forgotten trades, so in the cities around the world we have again small car services shops, shoemaker shops and shops for repairing electric devices. In the pervious decades, life was simple and expensive. For example, when something was damaged (if something would break or simply if something would fall off from a shoe), it was simply thrown away and a new thing was bought. The crisis, however, taught many that things can also be – repaired.

Thus, e.g. a car service owner Alexander from Arizona says that the business is going well in spite of the crisis, or maybe just because of the crisis. “When they come to see me, the customers know that we won’t lie to them, that the tire will not be just as new, but they know that they will be able to drive with it”. Considering that in the USA more than half a million employees lost their jobs this year, and that new firings are expected, the sale of new merchandize – from cars to domestic devices is in heavy crisis, while the craftsmen are satisfied. Savings will become something people will have to accustom themselves to in the months to come. “People want to save. They want their tires to last until they get some money”.

Or, a shoemaker Mr. Switzer in Ohio, who also apart from the shoes, repairs purses, suitcases and other things made of leather, says that his business was increasing in the last year, since the crisis lasts, and that now he gets between 70 and 100 items to repair a day. “Many people say that they will rather give 40 dollars for shoes repair than 100 dollars for a new pair.” However, even when he finishes the repairing, Mr. Switzer is not sure he will get paid for the work. A pile of brown paper bags under his bench with shoes nobody is coming to pick up is getting bigger.

The majority of repair companies are small, often family businesses and stores, but in the crisis bigger companies “flourish” as well, such as chains for sale of spare parts for cars “O’Reilly”, whose work goes better than ever thanks to the fear of Americans form indebtng themselves to buy new cars.

Work is going well for companies for renting furniture and white technic as well. Such a company “Rent-a-center” from Texas, which rents everything, from refrigerators to flat-screens TVs, with the possibility to buy the rented things later, had a positive year compared to the previous year’s “minus”.

In Fenix, in Arizona, a craftsman for repairing guitars Mr. Supper says that the recession drastically increased the number of musicians who bring their own instruments. More and more fellows come with words: "I know that this guitar is ruined, that its life is nearing its end, but I have no money to buy a new one." That are their tools and they can not do without it. It's like a hammer to the construction workers – says Supper, whose services often do not cost much less than 200 to 300 dollars, which is the amount needed to buy a new instrument. "My customers often tell me that they lack those 50 dollars needed to buy a new guitar."

Conclusion – Even though starting a business during a recession does not seem a smart move, it was shown that a period of slowing down of the economic growth can actually be an ideal one for the success of the company. During the economic crisis many famous and successful companies were founded, whose founders recognized the need on the market, whether in catering, technological companies or the fun industry or fast food industry, which is the key point in improving the business regardless of the economic climate from which it grows.

New time has also shaped a new man who is faced with problems and challenges of the time in which he lives. Every crisis is also an opportunity to redefine one's values and to put emphasis on the creative potential originating from it. New situations hide advantages in them which should be recognized and one should be ready to use them at the right time considering the fact that after every crisis prosperity comes.

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mr Nikola Perović

Global crisis in wine industry

Abstract: *Competition at the international wine market is very severe, more than it is common for many other sectors. Therefore, global trends and processes, consumer habits, innovations in technology, etc., always influence this industry. The latest economic recession, which became worldwide, will bring many changes. The global crises shall extremely affect international wine market.*

Key words: *industry, competition, rivalry, barriers, crises*

Resumee: *Der Wettbewerb am internationalen Weinmarkt ist sehr ernst, mehr als es in vielen anderen Sektoren üblich ist. Aus diesem Grund wird diese Industrie von globalen Trends und Prozessen, Konsumentengewohnheiten, Innovationen in der Technologie etc. immer beeinflusst. Die derzeitige wirtschaftliche Krise, welche weltweit zu spüren ist, wird viele Veränderungen bringen. Der internationale Weinmarkt wird von der globalen Krise extrem beeinflusst.*

Schlüsselwörter: *Industrie, Wettbewerb, Rivalität, Barrieren, Krise*

Резюме: *Конкуренция на мировом рынке вина, как редко в каком секторе очень интенсивна. Таким образом, этот сектор всегда находится под влиянием глобальных течений и изменений в тенденциях, потребительских предпочтениях, технологических инновациях и тому подобное. Последняя экономическая рецессия, которая на этот раз приняла широкий международный размах, принесет много изменений. Глобальный кризис очевидно оставит последствия и на международном рынке вина.*

Ключевые слова: *промышленность, конкуренция, соперничество, барьеры, кризис*

Introduction

The subject of this paperwork is not causes, but consequences of the global crisis, which has started in 2008, and its influences on world wine industry. Causes of this and generally of all economic crisis was explained by M.Friedman in his well known book "Freedom of choice" by following words: "the crisis (during 30s of XX century-remark by author) was not a result of mistakes made by entrepreneurs but those made by government in one part where it had responsibility from the very beginning"¹¹². The crisis in wine industry did not occur as a result of winemaker's mistakes, but as a result of government's omissions to manage cash flows using

* Company "13.jul Plantaže", Podgorica, Montenegro

¹¹² Milton&Rose Friedman: "Freedom of choice", Global book, Novi Sad, 1996., p. 90

adequate banking control mechanism. Therefore, the bottom line is that government (governments) failed to implement and control its own rules. What are the changes in economic policy that will occur due to the crisis? Will it come to change how we understand market economy in many countries (return to 'Keynesians' according to the decision of the USA President to appoint Nobel prize winner Paul Samuelson as an chief advisor, since he accepts Keynes's arguments that market economy is driven by fiscal policy and deficit consumption)¹¹³? Having in mind nature of this paperwork, subject of analysis is a global wine market, which has been affected, as all other markets, with the current (new) crisis. From one side, the changes are different among countries, but they can also be investigated using global industrial analysis by Porter's five forces¹¹⁴ (power of buyers, barriers to entry, rivalry, power of suppliers, and substitutes), which will be in the focus of the paper. According to previous research and expert forecasts, we shall try to formulize effects of global crisis on global wine business.

Global wine market

Decline in the wine consumption of 15% is expected in 2009, according to optimistic scenario, while pessimistic one forecasts decline of 25-30%. The decline in both scenarios as a base has consumption in 2008, even if we have decline during this year of French wine export of 10%¹¹⁵. Therefore, question is if we expect decline of turnover of all wines, or just certain categories? Will all large buyers-distributors survive the crisis? Using Porter's analysis we shall try to give answers on those and other major issues concerning worldwide wine industry. The point is not to give long-term prognosis from the analysis, since it will be in great extent result of exogenous variables, and therefore the wine business recovery will be a part of general economic recovery of the world.

¹¹³ Nathan Gardels: "Don't expect recovery before 2012", NPQ-New Perspectives Quarterly, Volume 26#1, Winter 2009

¹¹⁴ Michael Porter: "The Five Competitive Forces That Shape Strategy", Harvard Business Review, January 2008, Cambridge, USA

¹¹⁵ decline relates only to 8 M of 2008, according to Meininger's Wine Business International, Vol.III, issue 6, December 2008, Neustadt, Germany

Review of wine market using Porter's industrial analysis

We will make analysis of wine market using Porter's five forces¹¹⁶, which means analysis of buyers on the global wine market, barriers to entry, rivalry among existing players, suppliers and analysis of wine substitutes.

Power of buyers. The analysis regarding buyers will concern changes in positions of modern retail, consumers and distributors. Due to the power of buyers-retail chains, which are in position of high debt due to expansions from the last few years, it is expected that buyers slow down payments to the producers, which will consequently slow down payments to the producer's suppliers, and we will have general liquidity crisis as a result. It is known that during the periods of crisis importance of cash increases, therefore producers will be forced to reduce investments in new capacities. It is important to mention problem of currency exchange rates at many markets (Russia, USA, Serbia, etc.). Consumer's loyalty is at a highest level of test during the crisis, therefore owners of developed brands should continue with marketing investments in order to preserve market share before beginning of the crisis, and consequently start from the same position once the crisis is over.

Retail chains in the USA will according to the research of IGD-¹¹⁷ increase presence of private labels, which are perceived as the best value products, meaning the best value for the lowest price. This is a reason why retailers like Kroger or Safeway heavily develop own brands (possible in wine sector as well), which they communicate intensively towards the consumers. It is obvious that we will have more promotional sales (with rebates) due to the stronger pressure of the customers. At the same time, due to the liquidity problems, retail chains will reduce their inventories, and consequently most of products, which do not meet sales targets, will be removed from the assortment much faster than it was used before the crisis. The focus will be on wines with high turnover. Retail chains and distributors will increase their pressures for the longer payment delays, but also for the lower prices. On the other hand, due to the higher pressures for more rationality in consumption, producers will be challenged to develop cheaper wines and/or less expensive packaging for the same quality of wine (bag in box,¹¹⁸ tetra pack, cans, etc.), or to develop less expensive production procedures (it is possible that large producers like from Australia dislocate-outsource certain phases of production, like bottling, into

¹¹⁶ Michael Porter: "The Five Competitive Forces That Shape Strategy", Harvard Business Review, January 2008, Cambridge, USA

¹¹⁷ Ibid, page 24

¹¹⁸ Oposed to the general opinion in our region, more than 30% of premium wines are currently sold in bag in box

destinations of import). According to the research done by Economist Group¹¹⁹ so called innovation in development of new products and packaging adjustments for lower priced products, and also general innovation for more rational production, will be popular during the crisis. Therefore, even if generally investments will be reduced, putting more money in order to have more rational packaging will be interesting for the producers. According to certain analysis¹²⁰ consumers will keep brand loyalty, but will reduce quantity they purchase. On the other hand, there will be consumers who will shift their demand to less expensive individual brands from the producer's broader family brand or the other producer's assortment. Therefore, distribution from higher to a lower price segment will take a place. This situation is especially evident in EU countries and Russia, where specifically we could have increase of demand for cheap wines from Bulgaria, Chili, or Moldova, due to reduction of purchasing power. Russian analytics estimate that the crisis will be the least dangerous for producers whose wines have retail price of 100 rubles or less, which belong to the lower price segment.

During the period of global crisis we shall face transformation of on-trade consumption to off-trade consumption. Due to the reduction of purchasing power and increase of uncertainty, consumers will be reluctant to go to restaurants, and that will have double negative effects: turnover in restaurants will be reduced, and we shall face transformation towards cheaper brands in off-trade since the demand for prestigious wines will be reduced, which are regularly ordered in restaurants. At the same time, the above transformation in consumption will negatively affect liquidity of horeca sector and the wines for that sector. Higher focus to off-trade consumption will make changes in the structure of marketing investments, and the producers will more aggressively make promotions in point of sales. Also, during the crisis, it is necessary to develop brands with added value for certain consumer categories, such as "feminine wines"¹²¹, because all the categories of consumers will be more sensitive and careful in the choice of the wines which deliver, by their opinion, correct balance of price and quality. More generally, consumers will be less enthusiastic to try new flavors, and they will be more focused on products previously tried, which have cultural background. Therefore, tendency in transformation of spirit consumption into wines will be slower (example of India where the consumption of whiskey has cultural background, opposite to wine consumption which is at beginning of development).

As the wine producers will have to use more rational management of all resources in order to survive, the wine buyers-distributors will also have to be very efficient in sales and logistics if they want to be "alive" after the economic recession. Even if

¹¹⁹ Progressive magazin, March 2009, Belgrade, page 48

¹²⁰ FMCG Conference, Progressive magazin, February, 2009, Belgrade

¹²¹ The global trend of increase in demand of rose wines is confirmation of the statement

the statement above is not specific only for wine industry, it is still very important because wine distributors, for example according to situation in Russia, have 2 to 3 times lower efficiency compared to distributors from other industries. For every salesman in the USA, we have two or three in Russia. According to the analysis of Russian experts from prestigious agency Kachalov¹²² in order to have efficient distributor company one salesman should have turnover of 200-250 thousands of the US dollars, which is currently far below Russian reality. That is why it is so important to have rational distribution of large wine buyers-wholesalers and distributors, to have better planning of weekly and monthly sales, better introduction of new products, more modern business procedures and better motivation of sales force. The role of modern retail-large retail chains, which will be in danger of insolvency due to the uncontrolled expansion, will be negative for distributors who are solely oriented to them. Therefore, for these distributors it is essential to transform a part of efforts towards traditional retail, at least this is important for the countries where previous big transformation of small stores to large chains happened, such as in Russia¹²³.

Barriers to entry. Barriers to entry will be increased for many players, due to the pressure for lower inventories, and at the same time, due to the reduction of investments in new markets, many companies will turn to domestic market as a condition to survive, which will again make harder to entry the market for new wine companies. Therefore, many wine companies will be reluctant to invest in new markets, but they will put more effort to keep the current positions at their strategic markets.¹²⁴ Simultaneously, economic patriotism will grow, and opposite to official claims of World Trade Organization, movements of “purchase domestic” will arise, which will increase barriers to entry for many wine markets in the world. Even if this process is expected during the crisis, it will have negative effects on competition in long-term, and consequently on general efficiency within wine industry. As a result of increased need for domestic production and lower prices during the recession, it is expected to have more copies and forgeries of wine labels in the countries with less developed protection of intellectual properties. At the same time, due to increased need for price reduction, export of wine in bulk could increase, specially to the countries such as Russia, which will develop its wine industry using imported raw materials, and that will also increase barriers to entry for all prospective exporters of bottled wines.

As a specific barrier to entry one can examine negative foreign currency rates in many countries. Global crisis influenced devaluation of US dollar, British pound,

¹²² www.kachalov.com

¹²³ www.alconews.ru

¹²⁴ Research of Economist group, Progressive magazin, February, 2009, Belgrade, page 32

Russian ruble, etc., compared to Euro, which put in a worse position all producers who invoice their export in Euro (it is opposite for all wineries with weaker currencies, such as Australia or South Africa, who are now in better position for export). Devaluation of Ruble for 30% compared to Euro, which occurred in the first quarter of 2009, made more expensive entry of many European producers (those with Euro currency), especially for small producers who are not financially ready to bear such risk of doing business at a long run. It is very similar situation at the US market with negative relation of dollar to euro. It is clear that in such situation producers from weaker currency countries have better position to keep and expand domestic markets and slow down entry of new competitors.

Rivalry. Wine industry compared to broader competitors from beer industry, spirits industry, etc. has more conservative business philosophy. Nevertheless, the rivalry among current market players is very high. The element of rivalry, which will heavily be affected during the crisis, is a brand. The value of brands will be tested. Generally, brand loyalty passes special tests during the crisis, so it is necessary to use marketing investments, which are highly efficient¹²⁵ in order to strengthen loyalty of current and to gain new loyal consumers. All those investments and innovation in new products and packaging adjusted to the needs of customers in the crisis, which was discussed above, will increase rivalry in the industry. Therefore, it is crucial to maintain and strengthen good relationships with current importers and distributors, especially with those with long-term cooperation. Policy of stable prices is very important for consumers, knowing increased price sensitivity during the crisis. Will consumers continue to be loyal to favorite wine brand heavily depends on the price segment it belongs. Owners of premium brands with high prices have negative position compared to those with less expansive brands. The positive ratio of price and quality joint with strong brand will have a bright future, but the ponder consumers dedicate to a brand will generally be reduced. Therefore, it is considered that New world wines, which have perception of positive ratio price-quality, will increase market share.¹²⁶ Only the strongest brands, which have real, solid added value for consumers, will survive the waves of the global crisis. Giving a fact that wine production depends on size of the harvest, which was reduced in certain parts of France during 2008, it can be concluded that number of wine producers will be decreased, knowing that many small producers can not sustain positions with lower prices of wine. That will only increase rivalry among existing wine producers. At the same time, orientation towards domestic markets due to the increased economic patriotism could decrease number of new players, and

¹²⁵ According to expert K.Barnes during the crisis those who maintain or increase their marketing investments have better market results in next 18 to 24 months, Meiningers Wine Business International, Volume IV, March 2009, Neustadt, Germany, page12

¹²⁶ Meiningers Wine Business International, Volume IV, March 2009, Neustadt, Germany, page10

consequently stronger rivalry for existing market players. Described behavior of buyers, specially retail chains, concerning inventory reduction and general attitude to have more narrow assortment, will have influence on increase in barriers to entry for new competitors in the global wine market, and consequently it can be concluded that the crisis will make "filtration" of competition for the future, after the crisis, market game. The pressure of the buyers, specially retail chains, concerning longer delays in payment and reduced orders to have better inventory management, will also influence decreased number of players at the after crisis market, because many wine companies will go bankrupt, which already happened to many distributors from Norway.

Power of suppliers. Due to the described tendencies of reduction in consumption especially for more expensive wines, many supplies for wines industry will have excess capacity. Therefore, the power of suppliers will be reduced, so the best wine producers should use the crisis to make a pressure in order to have better purchasing terms. The crisis in wine industry can make changes in relations between wineries and top glass manufactures, with second traditionally in a better bargaining position, in the favor of wine producers. Nevertheless, the crisis is a confirmation of necessity for cooperation, and consequently those who have good partnerships with suppliers, are in a much better position to be more flexible to modernize and become more efficient.

Substitutes. Will demand grow for spirits, beer, cocktails, non-alcoholic beverages, water, etc? Reduction of purchasing power and changes in a consumer behavior will influence higher demand for less expensive alcoholic beverages. Even if we have a trend of consumption transformation from vodka to wine (markets of former Soviet union, Eastern Europe), this trend will be slower. The mostly damaged will be segment of high quality wines and premium price segment of alcohol beverages. At the same time, so called culture of cocktails, which has been developing in clubs for a while, will be slow down, because horeca in general is specially damaged during the crisis. It is expected to have certain substitution of wine consumption by beer, but at the same time certain level of cheap wines will overcome beer consumption. Final relation of wine consumption towards its substitutes will highly depend on capabilities of wine industry to deal with global market changes by innovation and new packaging adoptions.

Conclusion

Implementing industrial analysis by Porter's five forces we identified the changes in buyer's power at the global wine market, barriers to entry for new market players, rivalry among existing wine companies, power of suppliers and wine substitutes. All the elements of wine industry will be or have been already damaged by the global economic recession, but we made special focus on most dynamic changes of buyers. Buyers will face liquidity crisis, which will spread within the whole supply chain of the industry. Retail chains will focus on high turnover positions (so called best value products which have optimal ratio of quality and price), due to the pressures of consumers towards less expensive products. These changes will orient producers towards less expensive packaging and general rationalization of wine production. At the same time, transformation of on-trade to off-trade consumption will occur. The crisis will influence "filtration" of distributors, since many of them will not survive a need for higher operational efficiency. The barriers to entry will be higher at many markets. A special challenge, in order to preserve position among the rivals, is a brand management during the crisis. Power of suppliers in wine industry will depend on long-term business relations, so the crisis will be an opportunity for those who have good management of relationships within a supply chain. Position of the substitutes will be affected by the capabilities and flexibility of wine companies to create innovations adapted to changes in wine customer behavior.

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Nina Radović

Crisis 1929-1932, Asian crisis and transitional crisis connected with today 's crisis! Whether the crisis is natural or is it a result of mistake?

Abstract: *In the paper the autor analyses the relation between three crisis: the biggest crisis in the history of capitalism 1929-1932; the Asian crisis and the current crisis which still affects us. The paper has three parts each of which present these crises and their specific characteristics.*

Key words: *crisis, recession*

Resume: *In dem Papier analysiert der Autor relationships zwischen drei Krise: die größte Krise in der Geschichte des Kapitalismus von 1929 bis 1932., Der Asienkrise und der aktuellen Krise, die immer noch Einfluss auf uns. Das Papier besteht aus drei Teilen und jeder Teil repräsentiert die Krise und ihre eigenen*

Schlüsselwörter: *Krise, Rezession*

Резюме: *В статье автор анализирует отношения между три кризис: самый большой кризис в истории капитализма, 1929-1932., Азиатского кризиса и фактического кризиса, который до сих пор влияет на нас.*

Ключевые слова: *кризис, рецессия*

Introduction

We are witnessing a crisis that it is most used word today. About her writing and speeches all on the street, television, in cafes, at conferences. Everyone knows everything about her. The Bible describes the first economic crisis in view of Pharaoh's dreams and Joseph's interpretation. Seven fat and seven lean cows - seven were prosperous years, which follows seven crisis.

And what is really a crisis?

Wikipedia Free Encyclopedia defines a crisis as problematic, break-even point associated with making decisions. "The crisis is in the economy, as well as medicine, sociology and politics of the professional term. Is the crisis a result of natural or errors?"

By studying the history of crisis and crisis cycle is coming to the conclusion that they are inevitable, they are natural. The intensity of crises in history, specifically the twentieth century, carried out in the amended form cyclic phase after major

* Montenegro Investment Promotion Agency (MIPA)

depression, such as for example those from 1929/32. The milder the crisis came in the period after the Second World War 1950/70. year, in order to re-intense the more acute cycle basis in the period 1972 / 5 and 1977 / 8 as now. It is not the same crisis 30 years ago and the current crisis.

1. The crisis from 1929-1932

The crisis 1929-32. also well-known as a major economic crisis, as well as the Great Depression. This world crisis capitalistic system has had for the consequence such mass unemployment labor force and other production factors that they are endangered survival the system. The economists has been to explain the causes such drastic unemployment all production factors and to find solutions for its relevant urban planning act.

Relying on the traditional understanding of the way of employment, labor and capital, most of the economists have explained the crisis of high wages that were narrowed accumulation fund capital investment and hampered activity. Therefore, the classicist economists proposed the abolition of the current state of measures to encourage the free formation of prices in the market. Automatism and economic laissez-faire principles were to themselves lead to solutions.

Such a traditional view had already previously been opposed by some economists. Criticism is the most complete expression given in the piece of John Maynard Keynes, figures that indicate a certain milestone in the development of economic thought and economists who contributed more than all the economic policies of developed countries. Keynes is placed opposite the thesis and gave a new explanation of depression and unemployment. According to him, the causes of the crisis and unemployment should not be sought in the demands of workers for higher wages and high rent, which fund the reservoir pressure, but conversely, the economic behavior of the capitalist class, which does not invest enough and does not stimulate economic activity. This thesis has not only been an attack on the capitalist economic rationality, but also the economic theory that is the rationality and rested.

According to generally accepted standards, the Great Depression began on "Black Tuesday", 29 October 1929th when there was a great crash of the New York Stock Exchange. Then, in a single day, the shares lost value, Dow Jones index, which measures the fluctuations in market value has fallen in just a few hours to 12.8 percent. In a panic, the owners of the shares started in a mere trifle to sell their stakes in companies in order to extract at least a part value. In this way, created a vast offer of shares which is in the next two days caused a further decline in the Dow Jones index of 23 percent more.

It was started a chain reaction of stock markets around the world, the value of shares fell headlong, and companies laid off workers have begun. According to estimates, since 1929. to the 1932nd The Dow Jones fell a total of 89 percent, reducing the value of stocks that are on the New York Stock Exchange took the tenth of its previous value. In simple terms, the company that you have the mid-1929th was able to buy for million dollars, the 1932nd is only worth 100,000 U.S. dollars.

However, this is a period marked by high unemployment, the ranks of the labor offices and ranks of the public kitchens where the unemployed can get a free meal. According to estimates, during the worst of the crisis, unemployment was slightly higher than 22 percent, but a large part of the people who worked were employed only a few hours a day, achieving wage with which it was almost impossible to survive.

Prices of agricultural products fell by 60 to 80 percent, and even farmers and rural parts of America are not easily overcome this crisis.

End troubles brought only "New Deal", a project that President Roosevelt has launched an extensive public works projects. Recipe was seemingly simple. Unemployed American masses the state hired to build a canal, street, area arrangement, where people get the reward. With this salary, bought the supplies, food, clothing, shoes, paid apartment, in one word, let the money in circulation. The end of the economic crisis, some analysts see the mid-1930s, while the other end of the Great Depression to take the start of World War II.

2. Asian crisis

For official day of the outbreak of the Asian crisis takes on 2 July 1997. when Bank of Thailand abandoned the fixed exchange rate until then introduces a fluctuating exchange rate baht to the dollar. This trend has spread rapidly to other Asian countries.

Currency devaluation was a harsh reality.

TeizoTaja, economic expert at the Daiva Institute for Economic Research in Tokyo said that Japan is one of the biggest debtor, but also one of the largest creditors in the world, which claims more than 900 billion dollars: "The loans are mainly allocated to Asian countries like South Korea and Thailand, which is now engulfed by recession, and are unable to return loans. "We have people debit, and rising unemployment has now led to some poor stick because they can not repay its debts," explained the Teizo Taja. The Japanese capital city property prices are falling for

almost one hundred percent, and investors and builders are no longer able to repay its loans.

The most vulnerable is the financial sector. In order to overhaul, it should drastically reduce taxes or to reach for new spending, which increased the public debt. On the other hand, the Japanese crisis had its roots deep in its history. Contemporary Japanese society has accepted the latest technology, but Japanese society is based primarily on traditional values and the time was not equal to the trend of globalization. Japan is situated at the crossroads. Some draw parallels with the crisis of Japanese society from the 1858th , when the Americans then closed to the ground, forced the opening. Since it's been more than 150 years, but the Japanese in their doubt be left unchanged. However, Japan has always been a leading economic power. Tokyo is a member of the OECD and the group "G-7, which includes the seven richest countries in the world, which in turn makes Japan a part of the Western world. The consequence of this dual existence is that Japan is not integrated into either the West or in Asia.

In order to overcome the financial crisis, many Asian countries have proposed the establishment of a special "Asian Monetary Fund". Already been planned and funding in the amount of \$ 100 billion. At moments it seemed that it could be an opportunity to Japan and play a leading political role in Asia. To the creation of "Asian Monetary Fund" should come in September 1997. in Hong Kong. But the inauguration was prevented at the last moment.

The question which arises is what would happen to today's world that Asians have made this their intention? Would today's crisis was weak and would do it all there?

Today it is again topical issue of world currencies. For the first time after the agreement Breton- Woods disputing that the dollar no longer be the world's currencies. It is a brave step forward!

3. The crisis nowadays

In this crisis all the more noticeable elements of the creation of a new civilization and the end of industrial civilization. The very financial crisis caused by an imbalance between the quantity of manufactured goods and services (the newly created value), on the one hand and the amount of money, money surrogates and derivatives, on the other. The current crisis began in America in this way. Produced the effects, which largely did not cover the goods, services and assets. With speculative transactions their value is increased, and that is not nearly the same value of newly created value is not increased. When people realize it, wanted to sell these papers. Their supply is growing faster than demand. The prices felled, falling stock market, bankrupt banks, the purchasing power of citizens is reduced. Reduced consumption, lower production and employment. Income tax because it is even more

reduced and are much less buying. Since consumers are not buying or investors do not invest because they do not know in which order the production of investment.

Politicians and central monetary authority, in order to increase demand and investment, reduce the cost of money and almost free money pushed investors to invest in order to demand and production increase. However, consumers because of the uncertain financial future, do not decide to spend. Give up the replacement of cars, household appliances, clothes, holidays and so on. as long as they do not restore faith in a better tomorrow. The current crisis has a number of sources. First, the wear of the financial and political structure formed at the end of World War II. The second is social work and private appropriation, and private profit and social costs.

The following is the source of the discrepancy of today's global manufacturing power and global political relations. The result of this development is a global imbalance - the wealth of the Western developed world financed by poverty in developing countries. According to the Breton Woods agreement, the U.S. dollar became the world's currency with the obligation of replacement of gold. International Monetary Fund, where most of the funds given Western developed countries should keep the stability of international finance and the World Bank, which raises funds in a similar way to finance infrastructure projects and development in underdeveloped countries.

This system began to distort the early 70s of the twentieth century. America in 1971. declared cease-replacement dollars for gold, and its spreads and trade deficits and high indebtedness are further undercut confidence in the U.S. dollar as world reserve currency. The introduction of euro dollar got a kind-such a competitive and less able to make their deficits as opposed to rest of the world. At the same time, all the more for the development of underdeveloped countries started to give Japan and Germany. The present international political order has been created on the political situation and the balance of power and power at the end of World War II. At the end of World War II were the only country that has had a financial and economic and military power was the United States. Japan and Germany were defeated and destroyed. China, India and Brazil were far from industrial development. Russia was a military and a political winner, but was economically exhausted.

Today's economic map of the world looks quite different. USA is still the leading economic, military and political force in the world. However, following Japan, Germany, China, India, Russia and Brazil, who were 60 years ago in a completely different position. Their economic power in today's world does not correspond to their position in world politics. Today's financial crisis hit the U.S. first, then Europe and Japan. Countries that have so far by the International Monetary Fund (IMF) support the less developed countries now need help themselves.

Today's financial crisis in America in the form of appearance is similar to the Japanese crisis of ten years ago. Exchange were falling, the banks went bankrupt, real estate prices fell. However, there is one important difference: Japan is in crisis as the world entered the lender and the surplus in trade with the world. America has entered into a crisis as the world's debtor is the deficit.

The current crisis is entirely the opposite currents and requires different solutions. Today's global crisis requires global solutions.

This is the beginning of the crisis and the industrial civilization that developed in one energy, ideology and structure. The solution to this crisis the biggest challenge and the challenges facing America. The question is how much it is prepared to its dominant role in the world over to someone else or to reduce its dominance. There is no country, nor in the near future such exist, which could take the position that had the United States, and the solution in sight in the direction of multilateralism. Unfortunately, no one country or one civilization indulge in its dominance is not without a fight.

John Rockefeller: "These are the days when many are discouraged. In 93 years of my life depression came and went, but always returning prosperity, and that will be this time."

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Hipotekarna banka predstavlja modernu banku univerzalnog tipa i nudi potpun finansijski servis, pri čemu je posebno usmjerena na segmente građana i malih i srednjih preduzeća.

Banka je prepoznala potrebe današnjeg bankarskog tržišta koje nameće posvećenost klijentu, kvalitetnu i brzu uslugu i što potpuniju ponudu.

Lični pristup svakom klijentu, diskrecija, brzina i fleksibilnost, uz striktno poštovanje dobre bankarske prakse, osnovni su postulati poslovanja Banke.

Banka i svi njeni službenici dosljedno izvršavaju naloge Klijenta, štite njihove interese, tajnost transakcija, usluga i podataka o Klijentu, a sve u skladu sa dobrom bankarskom praksom, međunarodnom praksom, pozitivnim zakonima i drugim propisima.

Zahvaljujući takvom pristupu Hipotekarna banka posluje stabilno i uspješno, bilježi konstantan porast novih renomiranih klijenata i opravdava povjerenje klijenata.

Cilj nam je da obezbijedimo što kvalitetniji servis svim našim klijentima i da istovremeno, zajedno sa drugim kolegama bankarima, proširujemo ponudu kvalitetnih bankarskih usluga usmjerenih prema građanima i preduzećima.

FINANSIJSKI SERVISI BANKE

POSLOVI SA STANOVNIŠTVOM

Tekući računi

Gotovinski i potrošački krediti

Depoziti

VISA kreditne kartice

POSLOVI SA PRIVREDOM

Platni promet

Krediti

Depoziti

VISA Business kartice

HB Klik (elektronsko bankarstvo)

INVESTICIONO BANKARSTVO (Custody – Broker – Dealer)

I zato, kada Vam je potrebna banka, Vi birate Banku

- koja prati i razumije Vaše Potrebe,
- u koju imate Povjerenje i
- na čiju Podršku uvijek možete računati.



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