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Replacement of Dominating Paradigm as Outcome of the Current Economic Crisis

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This paper compares the fundamental postulates of neoclassic paradigm and Keynesian model with the modern capitalism. It shows that neoclassic paradigm, which underlies economic structure of major countries, is inadequate to the essence of market economy. The research concludes that the current crisis in the countries with both advanced and developing market economy has happened because their economic structures, each on its own way, have ignored the requirement of the systematic government regulation due to basing on neoclassic paradigm. Keynes model, which in fact has never been implemented, may be a base for a revised holistic, stable, and robust economic structure – for a “new capitalism”.

Keywords: economic crisis, financial crisis, neoclassical paradigm, Keynes model, modern capitalism, government intervention, economic stability.

Introduction

It is a tragedy when people become subservient to the economic system they live in. It is not right when they are regarded as mere tools and are not able to influence the system. People indeed make the system and they are who can change it for the better. The economic system does not need to be modified if it provides the desired results it is made for. If not, it can and should be altered.

Economists thought depression is a thing of the past until now when unprecedented financial crisis of 2007-08 has reached a scale which nobody forecasted, and has produced the current economic crisis. Under these circumstances it is

a critical time to revise the existing economic system. Economists should offer a new holistic, stable, robust economic system that will not suffer such recessions. And this should be started with the paradigm, underlying the new economic system.

Statement of the Problem

Three years have gone from the beginning of the current firstly financial then economic crisis. There have been suggested many hypotheses on the reasons of the crisis. The most often mentioned are the following ones: a difference between managers and owners in motivation and behavior (Heinsohn et al., 2008; Schwarcz,

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2008; Stiglitz, 2008; Arner, 2009; Bruni, 2009; Hellwig, 2008; de Haas et al., 2010), a separation of the financial sector from the production in the developed capitalism (Grinberg, 2008; Krugman, 2008), a long-term transformation of the economy of advanced countries from a robust financial structure in the 1950s to the fragile one that existed at the beginning of this crisis in 2007 (Lahart, 2007; Murphy, 2008), an insufficient margins of safety, based on how creditworthiness is assessed due to new financial acts (Blanchard 2008; Follmer 2008; Haas, et al., 2009; Maskin 2009).

Identification of the precise reasons is of utmost importance, as it is a necessary condition to implement the measures of avoiding such contractions in the future. Now the countries use ordinary measures of softening of the crisis's displays. But just playing around with taxes and government expenditures cannot eliminate the deep reasons of the crisis and thus this strategy is just putting off a new, more severe and large-scale display of the crisis, which is a product of controversies in the economic system.

In the 90's in the U.S.A. the growth of economy and welfare went on continuously for 120 month, in the state of euphoria people were gambling with the stock market more and more and the quality of the stocks was becoming less important. But the constant enrichment cannot be brought by the appreciation of the paper – without the growth of production. It is precisely a soap bubble. It can not inflate constantly, so it pops. And the anti-crises measures, used by the countries now, are just creating another such bubble.

Driving the problem deeper is not allowed. The current crisis is the result of long accumulated controversies in the economic systems of most countries, both advanced and developing ones. And the above listed reasons of the crisis have one common basis – it is the use of inadequate to the

modern form of capitalism neoclassical paradigm while building the economic structure. This is the deep reason of the current world economic crisis in our opinion. And the aim of this survey is to prove this point and also to show that Keynesian paradigm is able to provide more robust form of capitalism, which will not generate endogenous processes leading to crises. To achieve this goal, we have studied the fundamental basis of the neoclassical and Keynesian models and have compared them with modern capitalism.

Results

For more convenience the results of the survey are given in Table 1.

1. As it is seen from Table 1, the research began from perhaps the most important postulate of the studied theories – relation to the future predictability. **Fundamental uncertainty** of the future is a key conception of Keynes model, like transaction costs in neoinstitutionalism, or path dependence in neoevolution theory. The uncertainty means that we are not able to predict what the results of our current choice in the future will be, even by means of probability distributions, as there is no scientific base of calculating these probabilities. J.M. Keynes wrote: “There is no scientific base for calculating any probability of these events [settlement of the definite price for copper or of the precise interest rate]. We just do not know it” (Keynes, 1936: 284).

In this aspect, uncertainty differs from risk, in the case of which the future can be described by means of probability distributions, as both the quantity of outcomes and the likelihood of each of them occurrence are known. It is worth mentioning that in neoclassical tradition the difference between the uncertainty and the risk is ignored, and these terms are used as they are synonyms (Neumann, 1928).

One should not mix up fundamental uncertainty of the future with ambiguity (Dequech,

Table 1. Adequacy of neoclassical and Keynesian ideas to modern capitalism

	Neoclassical Paradigm (NP)	Keynesian model	Modern capitalism (MC)
1	Future can be predicted by means of probability theory. So NP proceeds from: 1) people are not interconnected; or 2) production does not take time. NP likens MC to the primitive economic system	Fundamental uncertainty: future is not predictable as substantial part of necessary information is not created. Uncertainty is a problem of complex economic system , where people are interconnected and decisions are irreversible	1. Capital facilities are used in production, so the future is connected with present and defined by it. 2. MC has a high degree of labour division, so people depend on decisions of others. So the MC is a complex economic system and the future is uncertain.
2	Real exchange economy: financial structure is irrelevant, as money is just a means to smooth exchange and is not sought for itself	Monetary production economy: money plays a part of its own and effects motives and decisions and so influences the allocation, production and distribution processes	Commodities need to be produced before they can be exchanged, so production needs to be financed and people care about their solvency and liquidity. So financial power of money is more important than purchasing, and MC is a monetary production economy.
3	Intrinsic stability of market economy: in real-exchange economy, under perfect competition, market forces help stabilize economic activity	Intrinsic instability of market economy due to dialectical nature of market mechanisms	System is highly dynamic and forever changing as competitive environment edges people through constant innovations which alter the structure of economy. Financial and economic instability is not rare event since beginning of 20 th century.
4	Temporary and limited government as market forces stabilize the economy themselves	Permanent and broad government as market mechanisms generate instability	Specific financial instruments during expansion periods are developed, and this destabilizes the economy, so the government should intervene continuously over the business cycle.

2000b). In ambiguity the future is uncertain but cognizable. Ambiguity is a form of uncertainty, which was investigated by representatives of classic economic theory, including Carl Menger, Eugen von Böhmer-Bawerk, Ludwig von Mises, and Nobel laureate Friedrich Hayek, so those who created the Austrian School. Each separate economic agent, including the state, knows almost nothing about awareness, preferences and expectations of the others. But the market gathers all this information together and generates right decisions. Therefore the state will never be able to reach such “good” results, as the market reaches.

The fundamental uncertainty implies not only unawareness of the future, but also its (the

future) incognizability. The latter is connected with the fact that the major part of necessary information has not been yet created. Thus, there are basic differences between the past, the present and the future. And it is the fundamental difference between Keynes’s and neoclassic theories. (Keynes, 1936; Arestis, 1966; Shackle, 1974; Dequech, 2000a).

In accordance with neoclassics economic environment is characterized by ergodicity. This means that the past, the present and the future can be described by the same function of probability distributions (Davidson, 1996). The time comes to the space, and movements in the time space in different directions are possible. So, this means

that people are able to predict the future for certain or by means of the probability theory, and that the future is not uncertain.

The fundamental uncertainty is a feature of non-ergodic economic environment. Keynes proceeded from the principle of historicity of the time. In accordance to it, the past is irreversible and the future is uncertain. So Keynes's model is founded on non-ergodic economic environment.

Now the question appears whether the modern economic environment is non-ergodic. After the study of Keynes's writing we can resume that the uncertainty as the basic characteristic of non-ergodic economic system, is a product of economic, social and technologic development.

The uncertainty is the problem of the "complex" economic system. The latter has two features. The first is usage of long-term capital facilities in production. As Keynes wrote: "The long-term capital facilities are precisely the fact why the future is closely connected with the present" (Keynes, 1936: 210). So, the future depends on the present choice in the economy with the long-term capital facilities, and the problem of irreversibility of the past and uncertainty of the future arises. The second feature is a high degree of labour division, due to which people are closely interconnected, so each of them depends on the decisions of the others. In such economic system the future cannot be certain. If we now look at the modern economic system of the vast majority of countries, we will see that they have both these features. So they are complex and non-ergodic economic systems. Thus, the neoclassic paradigm in its base is inadequate to modern capitalism. And Keynes's model is so far adequate.

Not every economic system is non-ergodic. The primitive one, which has no at least one of the above mentioned two features, is ergodic. The economic system, which does not use the long-term capital facilities, does not take the form of time space, so does not have the problem

of irreversibility of the past and uncertainty of the future. If the economic system has a low degree of labour division, there is no inevitable economic interconnection between people, so the future is quite certain. Neoclassic paradigm, taking as the base the prerequisite of economic system's ergodicity, likens the modern economy to primitive societies, and so fails to take important interconnections of the modern economic system into account. One of such is the role of money.

2. The **role of money** in economic system is the next fundamental difference between neoclassic and Keynes's paradigms. Neoclassic economists assume that the study of barter provides a good proxy to understand all economic systems (tribal, command and capitalist ones). In a barter theoretical system economic agents have a given amount of resources and market exchange allows them to strengthen their positions by obtaining the goods desired. Money may be added to the story but it does not change it substantially, or at all, the conclusions drawn from pure barter. Money is just a means to smooth exchange and is not thought for itself; individuals care only about the material gains and losses from exchange before making a decision so that "prior to the introduction of informational asymmetries, [...] financial structure is irrelevant" (Getler, 1988: 581). Once those gains and losses have been determined in a set of complete markets, all exchanges are executed instantaneously for all present and future contingencies, and nothing changes unless "shocks" affect the system. The future is known with certainty at least in the sense that all contingencies have been priced correctly and included in decisions. Moreover, if as a result of a shock someone decides to reverse a decision, this can be done easily and immediately.

Keynes called the previous system a real-exchange economy (Keynes, 1933) and argued that it does not apply to capitalism. Capitalism is a monetary-production economy. Indeed, in the

modern economic system of both advanced and developing capitalistic societies commodities need to be produced before they can be exchanged, and production is undertaken with the expectations of selling output, takes time to be implemented and completed, gathers groups with different economic interests, and involves irreversible decisions. All this is done in the context of a competitive environment that emulates monetary accumulation and imposes monetary return targets. Thus, capitalism has two silent features, it pushes individuals to anticipate an uncertain future in order to get an edge against competitors, and financial considerations are at the heart of the system. Consequently, “money plays a part of its own and affects motives and decisions” (Keynes, 1933: 408) and so influences the allocation, production and distribution processes (Veblen, 1901). Another consequence is that the system is highly dynamic and forever changing; stability is inconsistent with the principle of edging others through constant innovations.

All this is in sharp contrast with the barter system; “money is not a patch that can be added at will to the theoretical framework” (Wray et al., 2000: 818), it must be at the heart of a theoretical framework that aims at understanding capitalism. In a capitalist economy, people focus on their liquidity and solvency and those financial concerns are inclusive of purchasing power concerns. Thus, more than the purchasing power of money, people care about the financial power of money, i.e. their capacity to meet financial commitments when they come due. The central importance of those financial attributes, however, is not based on asymmetries of information but on the nature of capitalist economies. Unfortunately, those financial aspects, which are at the core of Keynes’s analysis, were pushed aside and made irrelevant by so-called “Keynesianism” of the mid-20th century (Patinkin, 1956; Modigliani

et al., 1958). Such “Keynesianism”, which was underlying the fine-tuning economic policy of the 1950s and 1960s in advanced countries, was back to Pigouvian world and the insights of Keynes were ultimately lost. As the fine-tuning tended to generate inequalities, inflationary pressures, and long-terms unemployment and resulted in a number of crises, it was rejected by economists, and Keynes ideas were also rejected, as they were incorrectly associated with the fine-tuning.

3. Differences in the view of both predictability of the future and the role of money result in the next difference between neoclassic paradigm and Keynes – view of what is intrinsic for capitalism: **stability or instability**.

In a real-exchange economy, under perfect competition market forces help to stabilize economic activity, they do not generate economic instability by themselves. The latter is a rare event that is generated by external factors like government intervention and random shocks. Government intervention is thought to be intrinsically unstable for two reasons (Friedman et al., 1963; Friedman, 1968; Kydland et al., 1977; Barro et al., 1983). The first reason is the assumed incompetence of policymakers to deal with economic problems, as well as the lags involved in policymaking, which lead to economic mismanagement, instability, and suboptimal economic results. The second reason is political interests, which, even if policymakers are well-intentioned, lead to time inconsistency.

An idea of intrinsic stability of capitalism leads neoclassic paradigm to the view on causes of cyclical development of the market economy. Neoclassic economists consider that only exogenous shocks can lead to economic crisis, and endogenous processes generate only an economic equilibrium. The current crisis emphasized weakness of this thesis, as no one of

the offered reasons of the crisis conforms it. As to government intervention, many economists, practitioners and casual observers of the crisis vice versa say about its insufficiency.

On the contrary, Keynesian based explanations of the current crisis prevail. Keynes stated that the market mechanisms have such structural problems as unfair distribution, economic instability and unemployment. So instability has endogenous nature and is intrinsic to capitalism. And perhaps the most cited theory of economic cycle today is Minskyan financial fragility hypothesis (Chancellor, 2007; *The Economist*, 2007; Lanhart, 2007; Magnus, 2007; McCulley, 2007). According to the theory, the structure of the capitalist economy becomes more fragile over a period of prosperity due to endogenous factors. Hyman Phillip Minsky has elaborated this theory on the basis Keynes's view of capitalism. He had his own opinion on Keynes's ideas and claimed Keynes was incorrectly interpreted by the mid-20th century's "Keynesians".

Minsky's research led him to conclude that capitalism is a highly dynamic system permeated by dialectical forces and circularities specific to this system. He argued that "stability is destabilizing," i.e. prolonged economic growth generates financial fragility, and that relevant business cycles are mainly "due to financial attributes that are essential to capitalism" (Minsky, 1986: 173). He noted that periods of financial instability are not rare events, but that since World War II their effects have been contained by massive government interventions. Minsky and others criticized Monetarists for being too restrictive in their definition of financial crises reducing them to bank panics (Schwarz 1988, 1998), and for brushing aside events that would have been catastrophic if the government had not intervened (Sinai, 1976; Minsky, 1986; Mishkin, 1991). Constant containment of crises' displays

without elimination of their basic reasons led to accumulation of controversies in the economy, resulted in such large-scale financial crisis of 2007-08.

Statement of Keynes and Minsky, his follower, about dialectical forces in market economy is true to modern capitalism. The dialectical nature of market forces was observed by many economists and practitioners. Thus, competition promotes economic growth and entrepreneurship, but it also promotes conformism and orientation to short-term projects (Galbraith, 1961). Innovations create new markets but also alter the structure of the economy, behaviours, and incentives and thus destabilize the economy (Applegate, 2007). Banks promote stability by carefully selecting borrowers, but banks also promote instability because of the structure of their balance sheet and because of competitive pressure to meet targeted returns (Wojnilover, 1977; Schinasi, 2006; Morgenson, 2008).

So, as Minsky noted "there is nothing magical about market forces" (Minsky, 1986: 203). And instability is intrinsic to the modern market economy.

4. Because Keynes and neoclassic paradigm have a diametrically opposed view of capitalism, it is not surprising that their view of the **role of government** differs greatly. In neoclassic paradigm, it is only if there are market imperfections, like price rigidities or asymmetric information, that the government has a role to play. The government should apply temporary, quick and targeted policies in order to compensate for those imperfections and to put the economy back on its "natural" path. Policy interventions, thus, may be good as long as the government does not try to push the economy above its natural path and the response is quick. This short-term fine-tuning should be complemented by a long-term policy that aims at promoting competition so that market mechanisms can play fully. So under

neoclassic point of view the government should be temporary and limited.

On the contrary, Keynes viewed the government as a necessary complement to the profit-oriented sector, as market mechanisms themselves tend to generate instability. Thus, according to Minsky's Financial Instability Hypothesis, market mechanisms tend to promote inflationary pressures and financial fragility as the economy tends toward full employment, so a major role of the government is to promote stable full employment, that is non-inflationary and financially sound full employment. This requires that the government intervenes continuously over the business cycle, rather than sporadically during downturns and upturns.

Government can help to stabilize the system through the cash-flow and balance-sheet impacts. In terms of cash flows, government expenditures and transfers provide some income to the private sector. In terms of balance sheet, a government injects liquid assets in the private sector. Government deficits also directly help to sustain asset prices because the latter depends on the discounted value of expected future profits (which partly depend on current profits). Finally, the government also directly helps to sustain asset prices by acting as a lender of last resort whenever necessary. The Keynesian multiplier is a common way to present the direct and indirect income impacts, but Kalecki's equation of profit is maybe more insightful to show the direct impact of government spending and taxing on the private sector. The macroeconomic monetary gross profit of firms is equal to (Kalecki, 1971):

$$\Pi = I - S_w + DEF + NX, \quad (1)$$

where Π is the gross profit after taxes; I is the gross private domestic investment, S_w is the saving of wage earners; DEF is the government fiscal deficit; NX is net exports.

According to Equation 1 there is a positive feedback loop between the gross profit of the business sector and its investment expenditure. Indeed, the gross profit of the business sector is sustained by its investment expenditure, which in turn depends on profit expectation of the entrepreneurs. This circularity of the capitalist economy is a part of the internal flaw of capitalism (Tymoigne, 2008). Thus, through its fiscal policy, the government sector helps to contain the destabilizing effect of this feedback loop.

It should be observed, that, like competition, innovations and banks, the government intervention has dialectical nature in the market economy. Though it promotes economic stability through its buffer programs and regulations but also tends to generate inflationary pressures and to promote moral hazard. In addition, competition pushes the private sector to try to evade, through innovations, the barriers put on profit accumulation by regulation. Thus, if the government is too slow to respond to changes in the economy, its regulations may become obsolete and may promote instability. But it reaffirms that the government should intervene continuously over the cycle. According to Minsky's cycle theory, given the institutional context, specific financial developments always tend to generate stagflation and/or recession, and the point of policy is to prevent, or at least constrain their developments independently of short-term profitability and short-term welfare gains. Thus, just before the financial crisis of 2007-08 in the U.S.A. innovative mortgage contracts and securities have been praised for allowing low-income households to become homeowners. Given the proper government financial supervision, those financial innovations should not have been allowed to exist and the crisis should not have happened at all or should not have had such large scale.

So modern capitalism, either in advanced or developing form, requires permanent and broad government.

Conclusion

The research showed inadequacy of neoclassical paradigm to capitalist economy. On the contrary foundations of Keynesian model correspond to base dependences of modern capitalism.

The main point of the survey is that the current crisis in the countries with both advanced and developing market economy happened because their economic structures, each on its way, ignored the requirement of the systematic government regulation and cut the participation of the government in the economic processes. If the growth of unsecured crediting in the advanced countries were noticed further, the crisis would not have been so severe. If Russia had provided appropriate institutions when transforming economy from the planned to the market model, monopolistic antisocial capitalism would not have appeared in the country. So neoclassic paradigm, which underlies the economic policy of majority countries, is inadequate to the complex, sophisticated system known as modern market economy. And the current world economic crisis vividly proved it.

Many economists bring forward the same thesis: the government regulation of the economy should be intensified. Thus, Nobel laureate Joseph E. Stiglitz wrote: “A ‘made in the U.S.A.’ financial crisis highlights the need for more global – and more robust – oversight”. Another Nobel laureate Paul Samuelson said: “...unregulated markets will generate their own demise, as we have seen.”

More over, many economists suggest rereading Keynes. Thus, Nobel laureate Paul Krugman said: “I believe not only that we’re living in a new era of depression economics, but also that John Maynard Keynes – the economist

who made sense of the Great Depression – is now more relevant than ever” (Krugman, 2008).

And here appears one thing, which is of utmost importance. One should not mix up Keynes’s ideas with their wrong implementation during the 1950s and 1960s “Keynesian” era. There has been certain mainstream interpretation of Keynes’s ideas. And this interpretation has been very different of what Keynes proposed. His ideas have been reduced to simple “fiscal activism”, also called “fine-tuning” of the economy. Fine-tuners think discretionary temporary measures help to maintain the economy on its non-inflationary employment path, and that it is the only relevant thing a government can do. On the contrary, Keynes’s ideas imply that market mechanisms are structurally flawed because they fail to provide full employment and economic stability. Keynes stood for a direct participation of the government through specific fiscal and monetary measures via cooperation between private and public sector (progressive tax policy, socialization of investments, etc.).

Now we know that fine-tuning, as a straightforward way to fix economic problems, is not the case. On the contrary, problems may worsen, as it happened in the mid-20th century. Fine-tuning did not allow the economy to reach full employment, did not reduce unfair inequalities, left aside the importance of supply management, and tended to create financial instability and upward inflation. This is all contrary to both the economic efficiency and Keynes’s ideas. Not in vain fine-tuners were named “Bastard Keynesianism” by Joan Robinson (Robinson, 1943).

Reduction of Keynes’s ideas to the short-term fiscal activism to manage demand led to their rejection in the 1970s after a number of crises, when the world got back to the radical liberalism, or in other words, neoclassical paradigm, under the slogan “back to Adam Smith”.

Unfortunately, the transformation of the soviet economy coincided with the new fashion of deregulation in the world. Unrestrained “invisible hand of the market” in Russia closed everything not related to the quick profit and “pipe” economy. Instead of starting to produce competitive goods Russian economy almost ceased the production of complete goods at the industrial scale. Therefore now Russian economy has no specific margin of strength and the recession here is more severe, than, for example, in Germany, which is on the first place in the world by exporting complete products.

So return to the radical liberalism has become the basic reason of the current world economic crisis. But one should note that crisis is not just an evil, but also purification. And we

should regard the current crisis as a sign to revise the existing economic system and to go to new capitalism. We suggest basing it on Keynes’s ideas. And in this model the necessary condition of the increase in the economic efficiency will be continuous over business cycle government intervention, as only in such form it is able to avoid lags in policymaking, generation of inflationary pressure and promotion of moral hazard – the well-known shortcomings of government interference into the market mechanisms. So only in such form, government intervention is able to provide stability.

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Смена господствующей парадигмы как итог современного экономического кризиса

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В статье проводится сравнение постулатов неоклассической парадигмы и модели Кейнса с современным капитализмом. Показано, что неоклассическая парадигма, лежащая в основе экономической структуры большинства государств, неадекватна самой сути рыночной экономики. Современный мировой экономический кризис и в странах с развитой, и в странах с развивающейся рыночной экономикой имеет одну основу – экономические структуры этих стран, каждая по-своему, проигнорировали необходимость систематического государственного регулирования из-за того, что строились на базе неоклассической парадигмы. Модель Кейнса, которая никогда реально не воплощалась в жизнь, может стать основой для обновленной целостной, стабильной и устойчивой экономической структуры, именуемой «новым капитализмом».

Ключевые слова: экономический кризис, финансовый кризис, неоклассическая парадигма, модель Кейнса, современный капитализм, государственное регулирование, экономическая стабильность.
