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STRATEGIC IMPLICATION OF THE RECENT FINANCIAL CRISIS

STRATEŠKI UTICAJI NEDAVNE FINANSIJSKE KRIZE

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Abstract
These are exciting times: the worst economic crisis since the Great Depression, the first global recession in the new era of globalization, and many goverment are committed to restructuring national priorities, and reforms, with the objectives eliminating some long standing distortions arising from corporate welfare, and restructuring tax code. By scrutinising the consequences of the ongoing crisis as well as the responses to it, it appears that it is necessary deeply reexamineg the whole approach to the economic system. This paper attempts to identify why economy change, and chnage of economy result wiht crisis. We do this by contrasting the most fundamental elements of the newly emerging reality with those of the old economy. We identifify the very significant departure from neoclassical economy and we can admit that the new objective of ideas is necessary to explain the real contrast two polar worlds . The common thread throughout these trade-offs is the increased role of knowledge, information and technological improvements.
Key words: . *economic crisis, new economy, market, failure, knowledge.*

Apstrakt
Ovo su uzbudljiva vremena: desila se najgora ekonomska kriza od Velike depresije, prva globalna recesija u novoj eri globalizacije, pa se mnoge vlade zalažu za restrukturiranje nacionalnih prioriteta i sprovođenje reformi, s ciljem eliminisanja nekih dugogodišnjih distorzije koje proizlaze iz korporativne dobrobiti i poreskih politika. Nakon analize posljedica zadnje ekonomske krize, kao i reagovanja na nju, čini se da je potrebno duboko preispitati ukupni pristup ekonomskom sistemu. Ovaj rad pokušava utvrditi zašto se ekonomija duboko promijenila zadnjih decenija i zašto su te promjene rezultirale krizom. To činimo upoređujući najosnovnije elemente nove nastajuće ekonomske realnosti sa starom ekonomijom. U radu se identifikuje vrlo značajno odstupanje od neoklasične ekonomije i može se ustvrditi da je potreban novi objektiv ideja da se objasni realni kontrast dva polarna svijeta. Zajednička nit kroz ove promjene je povećana uloga znanja, informacija i ostvarivanje tehnoloških poboljšanja.
Ključne riječi: *ekonomska kriza, nova ekonomija, tržišni neuspjeh, znanje.*

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1. INTRODUCTION

To introduce frame of the discussion it is important to note that in the history of capitalism, there have actually been crises almost continuously for the past 200 years except for during one short period, the 25 or 30 years after World War II. Since 2008 year, the world has been going through a major crisis, the worst since the Great Depression. The prevailing opinion about cause of the crisis is financial system failure. Author of this paper doesn't agree with this opinion, and thinks that the almost equal contribution is regulations, therefore governments. The author is going to contribute this hypothesis.

This paper will concentrate on one of the big issues going forward - how to build a crisis resilient economic system. In order to understand what we need to do to be more resilient than we've been in the past, one has to understand the lessons of this crisis and the hundred or so other crises that the world have experienced. However, it isn't easy endeavor due to that economic knowledge hasn't provided full frame for understanding the crisis over history. I would say that, it is evident with facing with new shape of crisis.

The additional motive for this paper is author's dilemma regarding explanation causes of the great depression, and the last recession with the financial system failure. Let's consider the prevailing explanation of current economic crisis, and myth of Great economic crisis.

2. FINANCIAL SYSTEM FAILURE

In short, in current crisis, and in Great depression, the financial sector went wrong is a very simple answer. But what is underneath, when we "peeling an onion" there is something tangible inside. So, in the case of financial failure, underneath appear many questions. Why did (does) the financial sector behave so badly? Why did (does) it misallocate capital? And why did things go wrong on so many levels? When you see something like this pervasively over and over again, you have to ask, what are the systemic problems? One thing that economists agree about is that incentives matter related to ongoing crisis.

Of course, at the core the problem was bad behavior on the part of the financial system. But, as Stiglitz (2010) said „financial systems almost always behave badly", so that is not a surprise. The problem was that the banks and others in the financial sector were not stopped from behaving badly by the regulators. Economists have explained the nature of the failures of the financial sector and why banks and other financial institutions often behave so badly, and also have described the kinds of regulations which should put in place to make the global economy more resilient, both at the level of individual countries and the global economic and financial system. (Stiglich, Krugman, and others).

After reading these explanations stay dilemma: Where is the problem: in market of state? The dominant point of view today, 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." There is economists who believe that the state is really the one which disable natural functioning of market mechanism and thus the state cause the crisis.

Let's put it in the framework of standard economic theory. What is capacity of economic theory regarding preventing the crisis? Stiglich pointed out that "We faced a crisis in economic theory: if we had not had the crisis, economic theory would have been repudiated" (Stiglitz, 2010). And the last crisis was predicted by economic theory since the incentives for bankers cause them to be engaged in excessive risk taking. Stiglitz pointed out that the crisis happened, and "economic theory was saved". But, according my view, the matter is not to predict crisis, equally important issue is to prevent a crisis.

3. FLAWED CORPORATE GOVERNANCE

It is possible to analyze this issue by state role in creating crisis. Again, it's like peeling an onion: we now have to ask why they (economic players) had such bad incentives. Who did wrong decision ant to whom? Did the shareholders? No, they don't. Did the bondholders? No, they don't. Did the taxpayers? No, they don't. Home owners and workers also lost. So who undertook the risk? The Executives of the banks. It is a problem of corporate governance -. It should be apparent: In America's system of corporate governance itself is badly flawed. Again, reasons for this badly behavior are also discussable: market or state incentives? Let's return again to economic science.

Economic science has been developing to identify circumstances that affect the costs of alternative choices, to analyze their implications for human decisions, and to make verifiable prediction about economic outcome. Economics, then, is the science of choice. Economics theories must explain a wide class of a real world events and yield observable prepositions. The economic concepts which have been developed for handling various problems are useful for handling a wide range of problems. Opportunity costs, supply and demand schedules, marginal costs, marginal revenue, and maximization profits – they're all very useful concepts that you can use. And not simply for economic problems but also for others as well. And the empirical work that is done is very useful. It is useful work which provides information within the existing scheme. But it isn't useful to explain why economic system changes (Why economics change?).

It is necessary to change way we look at the problem. If we study what economists have said about their subject, how do they describe it? Take John Manyard Keynes, John Hicks, Gary Backer. According to Keynes economics is a method, it is a way of thinking, not a doctrine. John Hicks says it is discipline, not a science. Lionel Robbins talks about economics as studying human behavior as a relationship between ends and scarce means which have alternative uses. Georgy Becker

talks about an economic approach. In effect what they are saying is that economics is a bag of tools, a way of analyzing problems, and it no doubt is. Also these tools use to analyze other subjects, for example, politics.

So, I agree with opinions that economics have to study not part of problem but the whole of it. That is to say, they don't think they're studying any system with all its interrelationships. "It is as if a biologist studied the circulation of the blood without the body." (Coase, p. 2). In fact economic system is extremely complicated. Haw parts of system are interrelated, how it actually works – is task of economy. Economics system can't explain only economics. We need more knowledge to understand how the economic system actually operates.

Within economy there are many decision makers, and adjusting decisions of decision makers has become more and more complex process. Within the context framework, decisions brought by individuals on their behalf, or on behave of government, corporations have created very huge problems in coordination, and regulations. The body of economic knowledge has been faced with fast changes in the real world. In finance sector new financial mechanisms have not been followed by the adequate regulations.

4. APPEARING NEW ECONOMY PARADIGM

According my opinion, the real economic life requires for development of a theory which explain the new phenomena. It is theory of "new economy". Weather is this theory departure from neoclassical economics. It is not purpose of this work to degenerate a theory that has made numerous contributions to our understanding of social and economic issue. It is, however, important to understand that theory of neoclassical economics does not explain a new phenomenon. In the new theory, the effect of innovations replace maximization paradigm. Flexibility and learning replaces assumption of a rational agent who is able to identify the optimal strategy in each situation without any learning process. "In fact, neoclassical economics is silent about both the effects of alternative rules on the agents' costs of acquiring the knowledge required to make optimal choices and the effects of new knowledge on prevailing rules" (Pejovich, p. 6). "… The only institutions existing in (the neoclassical model) are markets of the competitive type in which all information on the economy must be transmitted through the prices formed in these markets. The economy is therefore assumed to have… none of the many social institutions that are created by societies to help coordinate their economic and social activities by offering information not available in competitive prices" (Schotter, p. 675)

Whether or not the neoclassical model corresponds to the real world? The main question is: is information perfect. The answer it is – not. Information imperfections are pervasive in the economy: indeed, it is hard to imagine, as Stiglich noticed, what a world with perfect information would be like. It is obvious that different people know different things: workers know more about their ability than

does the firm; the person buying insurance knows more about his health, whether he smokes and drinks immoderately, than the insurance firm; the owner of a car knows more about the car than potential buyers; the owner of a firm knows more about the firm that a potential investor; the borrower knows more about his risk and risk taking than the lender. The essential feature of a decentralized market economy is that different people know different things; in this sense, "economists had long been thinking of markets with information asymmetries. But the earlier literature had neither thought about how they were created, or what their consequences might be. Moreover, while much of the earlier literature focused on simple situations of information asymmetry, the problems of information *imperfections* run deeper." (Stiglich, p 56). The individual may know little about his true health condition; the insurance company, through a simple examination, might even become more informed (at least concerning relevant aspects, e.g. implications for life expectancy). Some of these information asymmetries are inherent: the individual naturally knows more about himself than does anyone else. Some of the asymmetries arise naturally out of economic processes.

The current employer knows more about the employee than other potential employers; a firm knows may find out a great deal of information in the process of dealing with his supplier that others may not know; the owner of a car naturally knows the faults of the car better than others – and in particular, he knows whether or not he has a lemon. While such information asymmetries inevitably arise, the extent to which they do so and their consequences depend on how the market is structured, and the recognition that they will arise affects market behavior. For instance, one of the important insights of work in this area is to show how information asymmetries lead to thin or non-existent markets (Akerlof, 1970). But this means that even if an individual has no more information about his ability than potential employers, the moment he goes to work for an employer, an information asymmetry has been created – the employer may know more about the individual's ability than others. The consequence is that the "used labor" market does not work well. Others will be more tame in bidding for his services, knowing that they will succeed in luring him away from his current employer only if they bid too much. If they bid less than his productivity, his current employer will match. Labor mobility is impeded. But that gives market power to the first employer, which he will be tempted to exercise. The recognition of this naturally affects even the "new labor" market.

5. TECHNOLOGICAL CHANGE

Recent years have seen a substantial increase in research on the relationship between information and knowledge and economic performance. One sign that there has been a fundamental shift is that direct production of goods and services no longer absorbs the preponderance of workers' time. In 1975, production of goods and services ceased being the occupation of the majority of U.S. workers.

Never before had a society been so productive that it could afford to assign most of its workers to white-collar tasks such as management, paperwork, sales, and creativity. As recently as 1900, production workers in goods and services accounted for 82 percent of the U.S. workforce. Over the course of the century, that number declined by large steps, to 64 percent in 1950, and to 41 percent in 1999. Managers, professionals, and technical workers, who are increasingly involved in creative activities, have risen from 10 percent of the workforce in 1900 to 17 percent in 1950, to 33 percent in 1999 (Nakamura, p. 16).

Perfect competition is the central paradigm economists have relied on to describe capitalist economies. This paradigm, which underlies Adam Smith's "Invisible Hand" theorem, focuses on production processes and abstracts from the informational tasks that managers, professionals, clerks, and sales workers perform. The paradigm of perfect competition was formulated by William S. Jevons, Leon Walras, and Carl Menger in the late 19th century, a time when direct production of goods and services dominated work. Is this paradigm still appropriate in an age in which innovation is such an important economic activity; millions of workers are employed in creative activities, such as designing, inventing, and marketing new products; and more and more economic activity is devoted to creating technical progress? Is the theory set by Adam Smith appropriate for waive of changes. It is not explain why economics changes! Theory set forth by Joseph Schumpeter and often referred to as creative destruction is a better paradigm for the emerging "new economy".

6. WHAT ARE DIFFERENCES?

I Localization versus globalization. The meaning of geographic space differs between the old and "new economy" In the old economy, the standardization of products and production reduced the importance of regional specific characteristics. As represented by neo-classical production function, production in the old economy results form the inputs of land, labor and capital (Romer, 1992). While these traditional inputs still plays a role in "new economy", knowledge has emerged as the most important factor of production. A recent literature from the new growth theory argues that knowledge differs inherently from the traditional factors of production in that it cannot be costlesly transferred across geographic space (Krugmman, 1991a and 1991B and Lucas, 1993). "This is why under "new economy" geography play a more important role in that knowledge trends to be developed in the contexts of localized production networks embodied in innovative clusters.

The empirical evidence clearly suggests that R&D and other sources of knowledge not only generate externalities, but also that such knowledge spillovers tend to be geographical bounded within the region where the new economic knowledge was created. That is,, "new economic" knowledge may spill over, but the geographic extent of such knowledge spillovers is limited. In fact, the geograp-

hic dimensions of knowledge remains a local phenomena, largely unchanged by globalization. On the other hand, globalization has made it possible to transfer information costlessly across geographic space. Under old economy, the traditional factors of land, labor and capital are predominant as source of comparative advantage. In the "new economy" the comparative advantage is based on innovative activity. An important source of this innovative activities is knowledge spillovers that cannot be easily diffused across geographical space.

II Change versus creativity. There is an inherent trade-off between change on the one hand and continuity, on the other. While the old economy depend upon continuity, the "new economy" provokes and thrives on changes. Innovation is present under both change and continuity. The difference is shaped by a distinction between incremental and radical innovations. Innovations can be considered to be incremental when that they are compatible with the core competence and technological trajectory of the firm . The implementation of such incremental innovations does not require significant change in the firm or its personnel. By contrast, a radical innovation can be defined as extending beyond the boundaries of core competence and technological trajectory of the firm. Both theoretical reasons and empirical evidence support the notion that firm are characterized by technological lock-in. The old economy was designed to absorb change within a given technological paradigm, and hence, the typical firms excelled at incremental innovation. By contrast, in the "new economy" capacity to break out technological lock-in in the imposed by existing paradigms is enhanced.

III Turbulence versus stability. The old economy was characterized by remarkable stability. This stability is characterized by product homogeneity and durability of demand, resulting in a constant population of firms, and low turnover rate of both jobs and workers. This stability was conductive to mass production. Just as Taylorism provided a marginal mechanism for ensuring the stability and reliability of workers in the production process, competition focused on the dimensions of prices but not necessarily product differentiation. The "new economy" is characterized by a tremendous degree of turbulence. It is economy in motion, with massive number of new firms entering each year.

IV Diversity versus specialization. Specialization is a prerequisite of a neoclassical economy. Diversity is preferable in the "new economy" Recent studies have provided evidence testing the impact of diversity versus specialization on the performance of regions, measured in terms of growth (Glaeserm GaseKallal, Scheinkman and Shleifer, 1992) and term of innovative activity (Feldman and Audretsch, 1999). These studies provide systematic empirical support for the thesis that diversity is more conductive to knowledge spillovers and ultimately innovative activity and subsequent growth than is specialization.

V Heterogeneity versus Homogeneity. There are two dimensions shaping the degree of homogeneity/heterogeneity. The first refers to the genetic make-up of individuals and their personal experiences (Nooteboom, 1999). The second dimension refers to the information set to which they are exposed. The old economy is

based on homogeneity, the "new economy" on heterogeneity. A world of homogenous economics agents promote diffusion but not innovation. In a heterogeneous population each individual has a unique information set (Olson, 1982). New ideas are mere likely to emerge from communication in a heterogeneous that in homogenous world.

VI Motivation versus Control. In the industrial era, labor was considered to be indistinguishable from all other inputs. Thus, the labor input in the production process was reduced to routine (Chandler, 1990). However, as the comparative advantage of advance industrialized countries in Europa and in North America become increasingly based on new knowledge, the command and control approach to labor become less effective. What matters less is requiring an established set of activities from knowledge workers and what matters more is motivating the workers to facilitate the discovery and implementation of new ideas. The central future of work is dealing with uncertainty As uncertainty replaces predictability as the main characteristic of the work environment women who deal with uncertain situations are more valuable in the "new economy". Thus, in "new economy" motivating employees to participate in the creation and commercialization of new ideas matters more then in simply controlling and regulating their behavior.

VII Market Exchange versus Firm Transaction. In an era where uncertainty is high and information is imperfect, market exchange tends to be more deficient than intra-firm transactions efficient relative to market exchange. In old economy, which was dominated by a high degree of certainty and predictability of information, transaction within firms tendes to be more efficient than market exchange. This is consistent with work of Coase (1937) and more recently by Williamson (1975), an analytical distinction was made between exchange via market and intra-firm transaction. Coase (1937) and later Williamson (1975) argued that the size of an enterprise will be determined by answering what Coase (1937, p. 30) articulated as "The question always is, will it pay to bring an extra exchange transaction under the organization authority?" Both Coase (1937) and Williamson (1975) emphasize that uncertainty an imperfect information increase the cost of intra-firm transaction.

VIII Competition and Co-operation as Complements versus Competition and Co-operation as Substitutes. While models of competition generally assume that firms behave autonomously, models of cooperation involve linkages among firms. These linkages take various forms, including joint ventures, strategic alliances, and formal and informal networks (Gomes-Casseres, 1996 and 1997). In the old economy competition and co-operation are viewed as being substitutes. This is because firms are vertically integrated and compete primarily in product markets. Co-operation between firms in the product market reduces the number of competitors and lessens the degree of competition. In the "new economy firms are vertically independent and specialized in the product market. The greater degree of vertical disintegration in the "new economy means that co-operation among independent firms replaces internal transactions within a large vertically integra-

ted corporation. At the same time, there are more firms, resulting in an increase in both the competitive as well as the cooperative interface. The likelihood that a firm may end up competing or co-operating with another firm is greater in the new economy. In addition, new and enhanced configurations bring independent firms together in new and unexpected ways.

IX Flexibility versus Scale. The classic manner for reducing cost-per-unit in economics under the old economy was through expanding the scale of output, or through exploiting *economies of scale*. In product lines and industries where a large scale of production renders a substantial reduction in average cost, large firms will have an economic advantage, leading to a concentrated industrial structure. The importance of scale economies no doubt contributed to the emergence and dominance of large corporations in heavy manufacturing industries such as steel, automobiles, and aluminum (Chandler, 1977). The alternative source of reduced average costs under the new economy is through flexibility. As Teece (1993, p. 218) argues, "Flexible specialization … and contracting may today yield greater advantages than economies of scale and scope generated internally." Industries where demand for particular products is constantly shifting require a flexible system of production that can meet such a shifting demand. There are four major sources of flexibility – technological, organizational, demand side and qualitative. These four sources of flexibility result in a decrease in the importance of scale economies.

X Stimulation versus Regulation The public policies emerging in the post-war period of the old economy dealing with the firm in the market were essentially constraining in nature. There were three general types of public policies towards business -- antitrust (competition policy), regulation, and public ownership. All three of these policy approaches restricted the firm's freedom to contract. While specific policy approaches tended to be more associated with one country than with others, such as antitrust in the United States, or public ownership in France and Sweden, all countries shared a common policy approach of intervening to restrain what otherwise was perceived as too much market power held by firms. Public policies constraining the freedom of the firm were certainly consistent with the *Weltanschauung* emerging from the theories and empirical evidence. Left unchecked, the large corporation in possession of market power would allocate resources in such a way as to reduce economic welfare. Through state intervention the trade-off between efficiency on the hand and fairness on the other would be solved in a manner that presumably would be more socially satisfying. Galbraith (1956) is the seminal statement on the role of government in the old economy, where state intervention typically involved the social partnership of big business, big government and big labor. This social partnership existed in nearly every Western economy. In the "new economy" the relevant policy question has shifted away from *How can the government constrain firms from abusing their market power?* to *How can governments create an environment fostering the success and viability of firms?20* The major issues in the "new economy" have shifted away from concerns about excess profits and abuses of market dominance to international competitiveness, growth

and employment. The concern about corporations is not that they are too successful and too powerful but that they are not successful enough. Jorde and Teece (1991) argued for the emasculation of the antitrust laws in order to enable American firms to co-operate and compete more effectively against their Japanese and European competitors.

XI Targeting Inputs versus Targeting Outputs Stimulation and regulation are not the only dimensions regarding the role of government policy in the "old" and "new economies". A second dimension involves targeting selected outputs or outcomes in the production process versus targeting selected inputs. Because of the relative certainty regarding markets and products in the managed economy, the appropriate policy response is to target outcomes and outputs. Specific industries along with particular firms could be promoted through government programs. The targeting of specific firms in selected industries was clearly a successful policy for Japan in the post-war period and helped the Japanese achieve the competitive advantage in industries such as automobiles and electronics. As Joseph E. Stiglitz (1996) concludes from "Some Lessons from the East Asian Miracle," "government interventions acting together" (p. 151) account for at least part of the post-war Japanese growth miracle. The success of Japanese industrial policy in promoting a broad range of performance criteria, spanning the trade performance to economic growth has been painstakingly documented in a number of systematic empirical studies (Pugel, 1984; Audretsch, 1989; Audretsch and Yamawaki, 1988; Noland, 1993 and Okuno-Fujiwara, 1991).

XII Local policy versus national policy. Important aspect difference between old and "new economy" is the locus of policy. Under the old economy, the appropriate locus of policy making is at the national or federal level. While the targeted recipients of policy may be localized in one or a few regions, the most important policy making institutions tend to be at the national level. By contrast, under the "new economy", the locus of overmnt policy towards business tends to be decentralized and regional in nature.

XIII Risk capital versus low-risk capital. Under "new economy", the traditional means of finance are not longer appropriate. Of particular importance is venture capital, which has traditionally been a form of finance for high-risk innovative new firm and informal capital market (Gaston, 1989, Gompers, 1999)

7. CONCLUDING REMARKS

The world is one. Where we are? We don't have global rules of law, we haven't global demand, we have debts, we have high unemployment. Debts have been increasing! All economies are concerned. The recent crisis is having consequences around the world. Nobody stays untouched. The world has been faced with specific changes, and doesn't have capability to manage them.

The core of the problem is that we are in the global world, and global market. Rules of law are still local! Global omarket and local rules of law explaining

everything. Without rules of law global economy doesn't function. Without it we have anarchy, and corruptions on the global level. The road is reinforcement rules of law, first of all, at the global level, which will allow functioning of the market.

Global institutional infrastructure is out of date. Despite of exceptions, overall IMF success can be perceived as very limited. It can be argued that although the Fund still satisfies its role of a money lender, it has failed its role with relation to predicting an consequently preventing the economic crisis.

At the global level, the world doesn't have enough demand. In absence of global demand, debts have been increasing as surrogate of the demand (private as well as public debts). Salaries have been declining, and debts arise as surrogate of income. In one moment, in the absence of real income, debts blow up till a point.

In analyzing causes of the recent economic crisis, one fact is unavoidable: it is redistribution of the world income. The world income has been concentrated in hand of small number of people. The best illustration of this is USA, where over 80% of income goes to 1% of population.

Unfortunately, global world system doesn't have institutional framework to manage accelerated and specific changes. G-20 hasn't bring up solutions, only move chairs on the Titanic.

The message of the author is development democracy, not only inside states, but also on the global level. The fundamental precondition for that is development and implementation rules of law on the local as well as on the global level. The author is optimist, in spite of a serious political obstacles, first of all, rivality between USA, and Asia.

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