ECONOMIC CRISIS, ETHICS AND TECHNICS: WHERE IS THE DRAWING LINE BETWEEN POSITIVE ECONOMICS AND NORMATIVE ECONOMICS?

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Abstract
A common distinction in economics is the difference between positive statements vs. normative statements. The former involves basic facts while the latter involves suggestions and opinions. Although this distinction is inherent in economics research and practice, the 2008 economic crisis precipitated the discussions revolving on this distinction. 2008 is considered to be a milestone in the history of economic thought as deregulated economies were moved back to regulatory models; but at the same time bankrupt banks and companies have been bailed out and the welfare state was sacrificed in Europe. While bankruptcy shifted from companies to governments as in the case of Hungary, Iceland, Greece, and Britain for example, economists and international organizations have made predictions that never materialised. Whether the crisis is at the bottom (technically speaking, the ‘trough’ in business cycles) and expected to bounce up or whether it is heading further down is a moot point. The economic crisis has not only debunked the credibility of economics as a profession but also exposed the ethical dilemmas inherent in economics as a normative discipline. In this paper, these dilemmas are presented and discussed.

Past (before 2007): Causes

There are various explanations for the financial crisis that started in 2007 and is still ongoing. One reason is considered to be lower interest rates which led to the availability of cheap credit. The antecedents of lower interest rates are the events of September 11 and the dotcom bubble. As a response to these two potentially damaging events for the U.S. economy, the U.S. government lowered the interest rates to boost investment and the interest-rate-sensitive consumption. However, at the same time, the USA is a high-debt country and these cheap credits had to be found somewhere else. This ‘somewhere else’ was China. The consumption- and cheap-credit-driven economy has spiraled up American debts to China. Another explanation focuses on the housing market only and implies that the crisis was not because of macro-level systemic problems; it was only housing-related and secondarily, finance-related. This is one of the official explanations of American politicians. The truth is this is totally a macro crisis that cannot be attributed to one particular market as the crisis has been the result of the self-proclaimed victory of neo-liberalism. While the Soviet Union was collapsing, Chicago school and Austrian school policies were applied, primarily in the USA, Britain, and in other countries which have followed the ‘big brothers’, such as Turkey. While the Asian tigers were roaring with state-driven models, the IMF, World Bank and other institutes of the so-called ‘Washington Consensus’ were recommending (carrot approach) and forcing (stick approach) so-called ‘developing’ countries to follow the U.S.-British way; i.e. to deregulate the markets, and to let the invisible hand take care of the economy. By providing subsidies for the agricultural sector in high-income countries and forcing low- and middle-income countries to abolish those subsidies in their own sectors, the Washington Consensus paved the way for the weakening of agriculture
in those countries and dramatically contributed to the global food crisis and poverty. By the
collapse of the Soviet Union the neo-liberal economic model was without a serious rival.
Furthermore, given the fact that the social welfare model of Europe was mostly the consequence
of the fear of socialist revolution, the main reason to keep a social welfare model had
disappeared. Without any rival, the neo-liberal model moved to deregulate many sectors
including finance and banking. The difference between commercial banking (low risk) and
investment banking (high risk) has been blurred by deregulation policies and banks were allowed
to get into higher levels of debt. In that sense, Stiglitz (2010e) states that “[o]n complex
economic matters, trust had been vested in bankers (after all, if they make so much money, they
obviously know something!) and in regulators, who often (but not always) came from the
markets. But the events of recent years have shown that bankers can make megabucks, even as
they undermine the economy and impose massive losses on their own firms”.

Economic geographer David Harvey discusses various explanations of the crisis:
1) Human Frailty: Some have attributed the crisis to ‘human nature’, ‘predatory instincts’,
‘instincts for mastery’, ‘delusions of investors’, and ‘greed’.
2) Institutional Failures: Some explained the crisis by ‘regulators asleep at the switch’ and that
“the shadow banking system innovated outside of their purview”, “therefore institutions have to
be reconfigured” and “it has to be a global effort”.
3) Obsession with a False Theory: Some blamed false belief “in the efficiency of the market” for
the crisis.
4) Cultural Origins: Some explained the crisis by cultural origins with racist overtones such as
“Anglosaxon disease”, and the crisis “as the equivalent of the IMF punishing the USA”, “defects
in the Greek character”, and ‘cultural values attached to homeownership in USA’.
5) Failure of Policy: Some explanations of crisis involve points such as “regulation of the wrong
sort” (Harvey, 2011).

All these explanations can be simultaneously correct and more reasons could be added: Another
explanation by the chief economic policy makers is about “missing the systemic risk” (Harvey,
2011). From a Marxist point of view, Harvey (2011) calls this as “international contradictions of
capital accumulation”. Harvey (2011) states that “in many ways the form of this current crisis is
dictated by how we came out of the last” and “the problem back in the 1970s was excessive
power of labour in relation to capital” from the capitalist point of view. The solution by the neo-
liberal economic policy implementers was that “labour must be disciplined”. Capital gained
access to the global labor supply and moved to ‘cheap labor paradises’ such as China by
outsourcing. Harvey (2011) continues “it’s not greedy unions or excessive power of labour this
time; it is excessive power of capital. Since the 1970s wages turned out to be the money that buys
goods. Where’s the demand come from? It has come from consumption habits, debt culture and
credit cards. The capital overcome the problem of effective demand by pumping up the credit
economy” (Harvey, 2011). In that sense, U.S. GDP growth did not originate from production, but
indebtedness and the housing bubble which could not have continued indefinitely without
bursting. That ‘day of reckoning’ has come. As a result of overinvestment in the 1990s, low
interest rates did not translate into more investment in the first decade of the 21st century, but led
to the flow of cheap credit to the housing market which fed the enormous bubble (Stiglitz, 2007).
Furthermore, economic markets were made less profitable than the finance markets, which led to an increase in the number of suppliers of financial services as well as the systemic risks associated with them. Since the past overinvestment made the easy monetary policy ineffective even before the financial troubles, some consider the crisis as an ‘economic crisis’ rather than a ‘financial’ one.

A connected form of explanation revolves on the notion of market concentration. As the crisis came out of the decisions made in the so-called “too-big to fail” banks and companies, such institutions will continue to pose systemic risks even after the crisis (Stiglitz, 2009a). Their decisions affect billions of people. Thus, they are not only dangerous for the economy, but also for the people of various countries. Unfortunately they are still powerful, as explained by Stiglitz (2008c): “This raises another problem with America’s too-big-to-fail, too-big-to-be-restructured banks: they are too politically powerful. Their lobbying efforts worked well, first to deregulate, and then to have taxpayers pay for the cleanup. Their hope is that it will work once again to keep them free to do as they please, regardless of the risks for taxpayers and the economy. We cannot afford to let that happen.”

One of the least mentioned causes behind the crisis is the cost of the wars in Iraq and Afghanistan. The U.S. continues to fight as if the Cold War is not over (Stiglitz, 2010a), and huge amounts of money are accordingly spent for non-productive purposes. Secondly, when the U.S. invaded Iraq and Afghanistan it was running deficits together with tax cuts. Therefore it has been clear from the beginning that this cannot be sustainable as explained by Stiglitz (2008e): “Normally, countries ask for shared sacrifice, as they ask their young men and women to risk their lives. Taxes are raised. There is a discussion of how much of the burden to pass on to future generations. In this war, there was no such discussion. When America went to war, there was a deficit. Yet remarkably, Bush asked for, and got, a reckless tax cut for the rich. That means that every dollar of war spending has in effect been borrowed.” Stiglitz (2008f) estimates the cost of Iraq War for USA to be $3 trillion! It also cost a second $3 trillion for the other countries involved. This is far more than the official estimate of $50 billion. Stiglitz (2008f)’s comment is noteworthy: “Americans like to say that there is no such thing as a free lunch. Nor is there such a thing as a free war. The US – and the world – will be paying the price for decades to come.” Furthermore, instability in Southwest Asia (or ‘the Middle East’ from the perspective of orientalist and colonial powers) caused by the U.S. invasion affects oil supplies and drives up oil prices which leads to increasing production costs. This not only triggers inflation, but also unemployment on a global level. In addition to this, oil-dependency and high oil prices lead to wealth transfers from oil-importing countries to oil-exporting countries.


The bankruptcy of banks and finance companies became widespread while GDP growth of high income countries plummeted. Bailouts, bonuses for CEOs and tax cuts for the wealthy have triggered popular anger and labor and student demonstrations have protested the privatization of benefits and nationalization of losses. Stiglitz (2009b) asks “[d]oes anyone really believe that America’s bank officers suddenly became so much more productive, relative to everyone else in
society, that they deserve the huge compensation increases they have received in recent years? Does anyone really believe that America’s CEO’s are that much more productive than those in other countries, where compensation is more modest?” The least productive has received the highest incentives to continue to be the least productive. However at the same time, popular support for the banking sector has almost disappeared. Many ordinary citizens hate bankers for their involvement in the crisis. As stated above, the big corporations are still powerful and their power is the real source of the problem as corporate irresponsibility is common. On the other hand, Skidelsky (2009) blames somebody first: “If we are going pursue the blame game, I blame economists more than bankers for the crisis. They established the system of ideas that bankers, politicians, and regulators applied.” This comment also makes sense from a Marxist point of view, as the economic relations produce and reproduce their own ideology, own ‘false consciousness’ and illusions. On the other hand, James (2009) shifts the blame from bankers to politicians: “Leading bankers were initially the most obvious culprits. They presided over institutions that made large profits for a substantial period of time by mispricing risk, and then argued for public support on the grounds that they were too big to fail. They appeared arrogant and overpaid, and were easily demonized. But what about the political process? Why were the banks not more closely controlled and better regulated? It is not that politicians were “bought” in a simple sense; rather, they convinced themselves that financial innovation opened the gate to greater general prosperity, increased home ownership, and, of course, popular support in elections.” From a more systemic point of view, all three corners of this triangle of economists, bankers and politicians can be blamed for various reasons.

Stiglitz (2011) summarizes the state of crisis in 2010 by the following remarks: “For Europe and the United States, 2010 was a year of disappointment. It’s been three years since the bubble broke, and more than two since Lehman Brothers’ collapse. In 2009, we were pulled back from the brink of depression, and 2010 was supposed to be the year of transition: as the economy got back on its feet, stimulus spending could smoothly be brought down. (...) In fact, 2010 was a nightmare. The crises in Ireland and Greece called into question the euro’s viability and raised the prospect of a debt default. On both sides of the Atlantic, unemployment remained stubbornly high, at around 10%.”

Future (after 2011): Consequences

The crisis led to the collapse of the EU and U.S. world order and the rise of China. Some call the new system as the ‘Post-American world order’. The winners are China and Australia. As the demand for metals increases in China as a result of aggressive infrastructure projects, Australia multiplies its revenues as China’s supplier. The crisis also precipitated Chinese investments in Africa and South America.

U.S. military and political withdrawal is expected. As an analogy to the ultimate Vietnamization of the war in the U.S. - Vietnam war, whereby South Vietnamese were eventually asked to fight and die rather than U.S. soldiers, and for the U.S. interests, Iraqis and Afghans will be asked to die rather than U.S. citizens. And even then U.S. victory is definitely not secured.
The currency war can be considered as a sign of the U.S. response against the Chinese ascension to power as the U.S. is looking for ways to depreciate the US Dollar to be more competitive, and ask China to revalue the Chinese Yuan. Although this may confer competitive advantage for U.S. exports in global markets, it may simultaneously increase the cost of living in high-income countries including the U.S., as low inflation rates in those countries are partially due to Chinese low-cost production, which can be called the ‘export of deflation’ (Stiglitz, 2008g). Furthermore, many countries are looking for ways to dispose of their depreciated U.S. dollars by buying gold (Chossudovsky, 2011) and other currencies. As the country with the largest international reserves, China is the most affected and its decisions will definitely determine the future global financial architecture. Furthermore, Chinese government plans to introduce the Yuan as a reserve currency in the future (Quinn, 2009) will weaken the embattled supremacy of U.S. Dollars in the global economy.

The IMF, World Bank and other institutions of the Washington Consensus have lost power and credibility and the consumption societies and – as a result – export societies are on their deathbeds. The death of consumption society invites the death of export society, as the exporter countries can no longer sell their products to U.S. and European consumers as they are now impoverished and dispossessed. Thus the death of the consumption society in the North Atlantic leads to structural changes in Asian economies. Boosting domestic consumption is advised for Asian economies, especially for the Chinese economy. As the past recommendations of the Washington Consensus led to deregulation of the financial markets and other sectors, Asian economies became more vulnerable to global crises except China and some other relatively close economies such as that of Vietnam. (source) The contagion effects observed in the Asian Financial Crisis (1997) are back with more intensity in the region. As the Asian crisis dethroned Suharto despite his 32-year-long iron rule in Indonesia, the question that comes to mind is: “Who will be dethroned this time? Which ‘leader’ in which country?” The answer is any ruler of a deregulated economy with a strong alignment with the North Atlantic economies. As the crisis is still not over and it will be around for a long time, the question will also be relevant for a long time.

The financial crisis is entangled with the economic crisis as consumption patterns and export patterns have been changing. Thus, reforming the banking system will not solve the problem. The Consumption-dependent global growth model will be replaced by a new model which is still under construction. Cutting taxes will not solve the problem either, as investors and consumers are not willing to spend when they are pessimistic about the economy; they would rather save and wait for what is next. Thus tax cuts do not lead to new jobs which would have lessened the unemployment problem (Stiglitz, 2009d). Furthermore, externalities of unemployment such as ‘crime’, suicides, and organized protests are also common. The crisis societies turn into prison societies and the leader in this transformation has been the U.S., even before the crisis. A good accounting practice should subtract these costs from GDP, but instead they are added as spending (Stiglitz, 2008b). So security becomes the major concern for the crisis societies. Thus by a better accounting standard, the negative growth of the crisis countries is even worse.

Although the future is bleak and the crisis may even continue for a decade due to implementation of the wrong policies that will increase unemployment and other economic evils, Stiglitz (2010d) has some suggestions which may show the way to salvage ‘the system’, but which at the same
time are hard to implement due to the power of the military-industrial complex: “There is a simple Keynesian recipe: First, shift spending away from unproductive uses – such as wars in Afghanistan and Iraq, or unconditional bank bailouts that do not revive lending – toward high-return investments. Second, encourage spending and promote equity and efficiency by raising taxes on corporations that don’t reinvest, for example, and lowering them on those that do, or by raising taxes on speculative capital gains (say, in real estate) and on carbon- and pollution-intensive energy, while cutting taxes for lower-income payers.”

The Status of Economics as a Profession: Technics vs. Ethics and Positive vs. Normative Economics

As various countries started to print money to find their way out of the crisis, the conventional monetary wisdom based on classical economics is no longer relevant. The economics textbooks and the databases of economics teaching need serious revision. In public opinion, economists have less predictive power than fortunetellers. “Almost without exception, mainstream economists failed to foresee the crisis, and even the few who did got the logic and unfolding of events wrong” (Palley, 2009). That almost no economist -except heterodox economists- predicted the crisis led to the total failure of the marketing efforts of economics departments, converging with the common view that economics departments focus on theories that are impractical, unnecessarily technical and useless to explain the real life issues. While pointing out the fact that there are multiple models proposed in economics that may be applicable in different cases, Rodrik (2009) states that “[m]acroeconomics may be the only applied field within economics in which more training puts greater distance between the specialist and the real world, owing to its reliance on highly unrealistic models that sacrifice relevance to technical rigor. Sadly, in view of today’s needs, macroeconomists have made little progress on policy since John Maynard Keynes explained how economies could get stuck in unemployment due to deficient aggregate demand. Some, like Brad DeLong and Paul Krugman, would say that the field has actually regressed.” Rodrik (2009) adds that “[i]nstead of presenting menus of options and listing the relevant trade-offs – which is what economics is about – economists have too often conveyed their own social and political preferences. Instead of being analysts, they have been ideologues, favoring one set of social arrangements over others. (...) No economist can be entirely sure that his preferred model is correct. But when he and others advocate it to the exclusion of alternatives, they end up communicating a vastly exaggerated degree of confidence about what course of action is required.” Converging with this line of thought, Skidelsky (2008a) states that “[a] few geniuses aside, economists frame their assumptions to suit existing states of affairs, and then invest them with an aura of permanent truth. They are intellectual butlers, serving the interests of those in power, not vigilant observers of shifting reality. Their systems trap them in orthodoxy.” Furthermore, Skidelsky (2008a) questions the scientific basis of economics: “The cycles in economic fashion show how far economics is from being a science. One cannot think of any natural science in which orthodoxy swings between two poles. What gives economics the appearance of a science is that its propositions can be expressed mathematically by abstracting from many decisive characteristics of the real world.”

Although the post-crisis conditions resemble those of the Great Depression of 1929 in assigning more popularity for Keynesian models, there are still some who blame Keynesian expansionary
policies for the crisis as if they preceded the crisis. Furthermore, unlike Keynesian recommendations, the fiscal stimuli were also used for non-productive purposes such as for the bonus of CEOs. Unregulated, non-productive government spending is definitely not a Keynesian recommendation. This blame on Keynesian policies can be partially attributed to a short-term understanding of the economy at the expense of a long-term understanding, and an exclusive focus on deficits ignoring the assets of countries, as explained by Stiglitz (2010f): “One has to look not only at what a country or firm owes, but also at its assets. This should help answer those financial sector hawks who are raising alarms about government spending. After all, even deficit hawks acknowledge that we should be focusing not on today’s deficit, but on the long-term national debt. Spending, especially on investments in education, technology, and infrastructure, can actually lead to lower long-term deficits. Banks’ short-sightedness helped create the crisis; we cannot let government short-sightedness – prodded by the financial sector – prolong it.” In other words, borrowing for consumption (present use) is detrimental, while borrowing for investment (future use) is beneficial for the economy, as the latter adds value to the resources. However on the other side of the continuum, Stiglitz (2010f) warns against what he calls ‘deficit fetishism’: “Over the longer term, most economists agree that governments, especially in advanced industrial countries with aging populations, should be concerned about the sustainability of their policies. But we must be wary of deficit fetishism. Deficits to finance wars or give-aways to the financial sector (as happened on a massive scale in the US) lead to liabilities without corresponding assets, imposing a burden on future generations. But high-return public investments that more than pay for themselves can actually improve the well-being of future generations, and it would be doubly foolish to burden them with debts from unproductive spending and then cut back on productive investments.”

The crisis also led to a process of questioning of the role and status of monetary authorities of each country (the Federal Reserve in the U.S.), as they were blamed for operating as private banks serving the monetary interests of the wealthy and especially financial capital, and as they were blamed for acting irresponsibly, unethically and shortsightedly; as concisely explained by Stiglitz (2010b); “[w]ith interest rates near zero, the US Federal Reserve and other central banks are struggling to remain relevant” and by Stiglitz (2010c); “[t]he Federal Reserve Board is no longer the lender of last resort, but the lender of first resort.”

Unfortunately, history is repeating itself if not in all aspects, then at least in the uselessness of monetary policies and irrelevance of monetary authorities as the solution finders in crisis times, as explained by Stiglitz (2010b): “John Maynard Keynes argued that monetary policy was ineffective during the Great Depression. Central banks are better at restraining markets’ irrational exuberance in a bubble – restricting the availability of credit or raising interest rates to rein in the economy – than at promoting investment in a recession. That is why good monetary policy aims to prevent bubbles from arising. But the Fed, captured for more than two decades by market fundamentalists and Wall Street interests, not only failed to impose restraints, but acted as cheerleaders. And, having played a central role in creating the current mess, it is now trying to regain face. In 2001, lowering interest rates seemed to work, but not the way it was supposed to. Rather than spurring investment in plant and equipment, low interest rates inflated a real-estate bubble.”
The crisis and governments’ responses to the crisis also showed that the distinction between positive economics and normative economics has been blurred for a long time. Normative statements of the dominant classical school of economics which were applied in various countries since 1980s (opinions, suggestions, recommendations etc) were treated as positive statements (basic facts, basic data etc). Even worse than that, positive statements were elevated to the status of untouched dogma by the mainstream economists. This blurring of positive and normative economics paralleled a move from ethics to technics as discussed by Skidelsky (2008b): “The key theoretical point in the transition to a debt-fueled economy was the redefinition of uncertainty as risk. This was the main achievement of mathematical economics. Whereas guarding against uncertainty had traditionally been a moral issue, hedging against risk is a purely technical question.”

The damage inflicted on generations of bright economics students is hard to mend, as innumerable numbers of graduates were indoctrinated and brainwashed by the dogmas of efficiency of the market, deregulation, and privatization. Stiglitz (2008a) uses the term ‘market fundamentalism’ to explain this phenomenon: “Economic theory had long explained why unfettered markets were not self-correcting, why regulation was needed, why there was an important role for government to play in the economy. But many, especially people working in the financial markets, pushed a type of “market fundamentalism”” (Stiglitz, 2008a). Furthermore the crisis has served as an extremely painful reality check for the neoliberal doctrine which is responsible for the crisis and the steep income inequalities before and after that. Stiglitz (2008d) adds that “[n]eo-liberal market fundamentalism was always a political doctrine serving certain interests. It was never supported by economic theory.” In addition the crisis also exposed the failure of rationality assumption that is central in mainstream economics: “A long line of research has shown that even using the models of the so-called “rational expectations” school of economics, markets might not behave stably, and that there can be price bubbles. The crisis has, indeed, provided ample evidence that investors are far from rational; but the flaws in the rational expectations line of reasoning—hidden assumptions such as that all investors have the same information—had been exposed well before the crisis” (Akerlof & Stiglitz, 2009).

On the positive side, the crisis is expected to empower alternative views and heterodox approaches in economics as stated by Akerlof & Stiglitz (2009): “Just as the crisis has reinvigorated thinking about the need for regulation, so it has given new impetus to the exploration of alternative strands of thought that would provide better insights into how our complex economic system functions – and perhaps also to the search for policies that might avert a recurrence of the recent calamity.” Another positive result for economics as a research area has been the realization of the fact that economics is limited in explaining real life events. These will lead to more collaboration opportunities for economics with various disciplines such as psychology (since the rationality assumption is contested), political science obviously, and sociology. The reality is economists as a whole did not fail, as heterodox economists were warning of the bubbles before the crisis; the ones who failed were the majority of the narrow-minded economists which were indoctrinated by neo-classical dogma. As a result the number of interdisciplinary economists with wider views is expected to increase because of the crisis.

Conclusion: Sustainability of Capitalism
Stiglitz (2011) provides useful clues to discuss the sustainability of the crisis-infested global system: “It has become fashionable among politicians to preach the virtues of pain and suffering, no doubt because those bearing the brunt of it are those with little voice – the poor and future generations. To get the economy going, some people will, in fact, have to bear some pain, but the increasingly skewed income distribution gives clear guidance to whom this should be: Approximately a quarter of all income in the US now goes to the top 1%, while most Americans’ income is lower today than it was a dozen years ago. Simply put, most Americans didn’t share in what many called the Great Moderation, but was really the Mother of All Bubbles. So, should innocent victims and those who gained nothing from fake prosperity really be made to pay even more?”

Agreeing with Stiglitz’s line of thought, one can add the following: A demarcation line for many undergraduate economics textbooks has been growth versus inequality. The mainstream economists were proud of defending growth over equality, as if inequality is a totally non-economic reality. GDP fetishism i.e. exclusively using GDP growth to measure the performance of an economy also contributed to the neo-liberal dogmas until the crisis, while China had been considered an exception. Now GDP fetishism is still powerful; but due to grassroots movements, economists and governments can no longer ignore the inequality-related problems because they realize that their sustainability is based on that.

The internal contradictions of capitalism were precipitated by the crisis. There are hundreds of thousands of homeless in the U.S., while a matching number of houses are vacant (Stiglitz, 2010c). This and other precipitated contradictions will lead to more violent clashes which may take the form of ‘creative destruction’. Although many experts are advocates of sustainable development, sometimes short-term unsustainability can be better, as it would lead to collapse which will force people to build the model anew with sustainability issues in mind in this second time.

The crisis cannot be solved by the existing policies as the key to the solution and sustainability of the system is more public participation and transparency as suggested by Stiglitz (2009c): “The US and other advanced industrial countries pushed globalization. But this crisis has shown that they have not managed globalization as well as they should have. If globalization is to work for everyone, decisions about how to manage it must be made in a democratic and inclusive manner – with the participation of both the perpetrators and the victims of the mistakes.” Finally as to the future of economics as a profession, it can be stated that more heterodox economists which value and promote public participation and transparency will be necessary for a progressive future that will be built on an equitable basis. This process will involve a great deal of unlearning to break the chains of neo-liberal dogma.

References


