

ON THE BUSINESS CYCLE AND THE FAILURE OF THE WELFARE STATE  
(AUSTRIAN EXPLANATION)

*O BIZNIS CIKLUSU I NEUSPJEHU DRŽAVE BLAGOSTANJA  
(AUSTRIJSKO OBJAŠNJENJE)*

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**Abstract :** *By addressing the consequences of the ongoing crisis as well as the stimulus packages implemented by governments it appears that time is near to start reexamining the whole approach to the economic system. The concept of the welfare state has been profoundly shaken. Fundamental thesis outlaid by the classical economics and the Austrian school are still very much relevant, as the need to face structural misbalances closely related to high public expenditures grows. The issues some EU member states have with the state of their public finances cannot emphasise that challenge enough. Though certain state functions keep their legitimacy it takes a refreshed definition of state. At the same time, there is a need to revisit economics and the relations between micro and macro aspect as well as to reexamine aggregates such as GDP. It is clear one cannot ignore the need of humans to live in community, but also the fact our decisions are motivated by various reasons and therefore could not be predetermined. Knowledge plays role of energy that moves market forces keeping entrepreneurs awake. Extinguishing that energy is a safe way to suffocate market forces. On the other hand, it is in the human nature to give strong legitimacy to the institutions of egalitarianism which causes the need to unify different scientific research in order to identify the long term trends. By reaffirming the Austrian business cycle theory and the need to revisit the boundaries of the state's interference into the economy it seems that economics need new energy of thought to invent a new general economics theory. This paper practices the hypothesis that consistent economic policy cannot but encompass rational nutshell of every economic theory in its mission to address the micro and macro characteristics of a concrete economy.*

**Key words :** *business cycle, preferences, discovery process.*

**Apstrakt :** *Nakon izučavanja posljedica krize kao i državnih programa oporavak ekonomije dolazi vrijeme za preispitivanje ukupnog pristupa ekonomskim sistemima. Koncept države blagostanja je duboko potresen. Fundamentalne teze klasične ekonomije i austrijske škole ne mogu se osporavati, dok potreba uklanjanja strukturnih debalansa usko povezanih s visokom državnom potrošnjom raste. Problemi javnih finansija pojedinih zemalja EU to dodatno naglašavaju iako mnoge državne funkcije ne gube legitimitet u društvu. Istovremeno, postoji potreba za novim pogledom ekonomske nauke na veze između mikro i makro ekonomije i preispitivanje agregata kao što je BDP. Jasno je da se ne može zanemariti potreba čovjeka da živi u zajednici, ali i neodređenost njegovih odluka koje su motivisane različitim razlozima. Uloga znanja ima funkciju energije koja pomjera tržišne sile budući pažnju preduzetnika. Gašenje ove energije je siguran put u sputavanje tržišnih sila. S druge strane, u ljudskoj je prirodi da daje snažan legitimitet institucijama egalitarizma iz čega proizlazi potreba sjedinjavanja različitih naučnih istraživanja u cilju davanja odgovora na pitanja dugoročnih trendova. Reafirmacija austrijske teorije biznis ciklusa kao i potreba preispitivanja granica državnog uplitanja u ekonomiji utiču na potrebu da ekonomska nauka nađe novu energiju misli u cilju kreiranja nove opšte ekonomske teorije. U radu se polazi od hipoteze da je za formulisanje konzistentne ekonomske politike potrebno ravnopravno tretiranje racionalnih jezgara svih ekonomskih teorija i njihovo prilagođavanje makroekonomskim i mikroekonomskim specifičnostima konkretne privrede.*

**Ključne riječi :** *biznis ciklus, preferencije, process otkrivanja.*

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## 1. Introduction

Every shock brings changes to the system, regardless of the area it hits. Technological shock determines further development and thus it is directly linked to the economic outlook and it affects further development of

the political system. There are numerous historical examples that underpin that case. Probably the most illustrative one is the rise of (from the global point of view) relatively small European nations which managed to eventually colonise the whole world by previously taking part in the military, technological and commercial compe-

tion to innovate. Contrary to, as it may have looked, the better organised and lot bigger oriental empires which were reined over by one central authority that by wielding instruments such as official religion and economic flows controlled all the society (Kennedy 2003, p. 12). Also, on the other hand, political shocks have direct impact on the economic trends, but can additionally influence cultural matrix of a society. Socialist revolutions and the social engineering that followed later on represent the obvious example. Therefore, it is logical to conclude that economic shocks significantly affect other characteristics of a society. After the Great Depression there were not only changes to the economic policies, but also arose different set of theoretical reflections. In the practical terms, there has been a significant growth in the public expenditures bringing along various state programmes which deeply affect further development of institutions, but the expectations of the economic agents of a society as well. Perception of an individual about what is expected from the state has changed<sup>1</sup>.

Undoubtedly, the ongoing crisis will move matters further. The question is only where to. Will the wheel turn back, or will the whole mechanism actually move to a different position? The author of this paper thinks that in the long run both the wheel will turn back and the whole mechanism will move to the new position. In order to follow and analyse that trend it is necessary to apply new approach in studying the relationship between micro and macro economic aspect - the relationship between an individual and the whole system. That can certainly not be a subject of a deterministic and mechanical consideration and projection. The quantum mechanics has responded to many a puzzle, but has not resolved the whole problem. That is why many physicists expect creation of the general theory of physics. Smith, Hayek, Keynes or Marx for example, everyone from their angle attempted to provide for the solution to understand economic system. However, it is evidently needed to look for the synthetic explanation as implications of the economic decisions cannot be discussed only from the aspect of economy. In fact, it is possible, but at the risk of drawing an inapplicab-

le conclusion in the real world. The debate about the role of state has never become an obsolete one as the ideological search for the limits of the government may start again.

From times of Thomas Aquinas and universal man in which religion dominated all the researches, step by step it has been specialisation that has taken over as a trend. It has become the dominant characteristic of the human scientific research of nature and society. It is realistic to expect a new trend of synthesis of the individual specialised knowledge to come up, as it becomes necessary to understand people's living context that is formed of many elements with religion being one of the most important ones.

## 2. Methodological individualism

One finds it impossible to understand the way society and economic system function without considering the exchange process on the market from the individual point of view. Individuals are principle agents of the exchange process as they make economic decisions. On the one hand, every economic analysis that pretends to provide for the answer to the question of the optimum allocation of resources that cater needs and maximises wellness of the society on the other. By doing so the bottom line is to consider the individuals' preferences.

Within the context framework, decisions brought by other individuals on their behalf, or on behalf of the government in different forms, have direct impact on how we adjust to those decisions. That is why there is no viable microeconomic research unless individual's behaviour is not taken into account. At the same time, no macroeconomic research can be credible unless we understand it is but the aggregation of the individual decisions.

Economic thought since Smith (even before his work) has been aiming at providing response to the question how can individual interests be harmonized in order to improve the wellbeing of a society. The labour division and the affirmation of the free trade principles begin with the consideration of individual views over economic actualities and grow into a macroeconomic picture. The point where classical and Austrian schools of economic thought part their ways is in the classical claim that *laissez-faire* principles implementation maximises overall wellbeing of a society by expanding its material wellness. Austrian school contrary to it focuses on the position of individuals and how satisfied they are at a certain point in time given the actual economic state of affairs.

In a decision making process all of us assess to what extent the consequences of that decision will be useful to us. By doing that we assess different alternatives in each and every case. Thus it becomes important for the economic analysis not only to consider matters from the point of view of individuals but also to bear in mind the fact that we are all different and with different preferences which suggests our decisions do not necessarily have to be same even if the overall context remains the same. For that reason, when methodological individualism as a prin-

<sup>1</sup> Colombatto discusses the issues related to legitimacy of the institutions and individual perception from the historical perspective. Instead of the question how to create better rules, or what the optimal size of the state expenditure is it is necessary to raise the question what it is in the heads of the individuals that makes state interference legitimate. He distinguishes three periods in that analysis. Gregorian era is linked to Pope Gregory VII who tried to use his dictums to achieve supremacy over the secular rulers. The outcome was comprised in the circumstance that there is a law - divine order. Secular period was characterised by the establishment of the relations between the rulers and the succumbed. In order to make states secular the legitimacy had to come not any more from the top but from the bottom. For that reason, the state rises as a protector of institutions in a society and helps implement social contract. The third period is the age of the social responsibility. The rule goes as long as the essential goal of enlarging happiness of the society is achieved. Individuals believe to be living in the context that enables them to seize chances that appear from time to time. As chances are unequally distributed it becomes legitimate to compensate for the vulnerable ones or the ones who are unjustly left behind. The classic cases are the labour market, health and education. Enrico Colombatto, Social Contracts and Historic Rules, ICER Working paper Series 05/2009

principle is applied to an economic analysis it goes without saying that one has to apply the complementary principle of the methodological subjectivism, too.

Some theorists (Mises for instance) saw there the possibility of developing an autonomous science that deal with human activity – praxeology. Opposite to animals human activity is a purposeful one. Additionally, Menger's economic analysis based on subjectivism was the key to understand the way economic thought is supposed to develop further. This is particularly important once we understand that the economic thought stagnated for the most of the 19th century (especially through the second half), or was getting subsided by the socialist doctrine. In parallel to Menger, other theorists also (Jevons and Walras) inquired into the field of subjectivism and preferences. They did it, though, from a different, more equilibrium based mathematical perspective though (Skousen 2005).

### 3. Business cycle

Economic debate on the role of state in the economic system lasts for centuries. Disorder in public finances was many times in human history merely the first act in a country bankruptcy drama, but not only that. Sometimes it even led to the social failure (for details Kennedy 2003). The issue of the public finances exposure is currently one of the most highlighted questions in today's economic policy. The response of the most of the countries affected by the crisis has mainly been the combination of the monetary and fiscal expansion – reduction of the interest rates, printing money, expanding public debt and gaping budget deficits. Having intervened to save the economy, now countries become the problem (*The Economist*, Feb 13th 2010).

To understand the problem one has to make one step backward and understand the cause of the trouble. To that end, various means of money (cash, deposits, loans generated by fraction reservations, securitised mortgage loans etc) had swollen the money supply and led the interest rate to the level below a „natural“ one. Market value of various sorts of assets was growing between 1985 and 2006 faster than the nominal GDP was which affected significant growth of the world liquidity (Ibid., p. 14). Consequently, it moved time structure of consumption in favour of the production of goods more demanding to produce from the complexity and length point of view. Put differently, it stimulated production of higher order goods, the ones further from present consumption. The global impression grew that the intended savings surpass by far the intended investments which helped inflate the bubble. Inevitably, capital goods inflation takes place. As those goods are further from the present consumption, in those industries it is manifested also in high volatility of their prices, quantity of production and levels of employment. Dramatic change in perception and expectations helped financial structure collapse, as it lost its liquidity – it seemed as money simply evaporated. By pumping money into the system one tries to resolve the

problem of liquidity, that is to maintain the same time structure of consumption though unsustainable – people reacted by adjusting their behaviour to the new set of information.

The size of the government expenditures, as well as providing finances against future taxes and by the same token level of the public debt become most relevant issues of the modern economic policy. The average public debt of the rich economies has leapt from less than 80% to about 100% of the GDP over two years, while the IMF reckons it will have grown to 120% of the GDP by 2014. Given the budget gap that stems from the actual crisis which ranges in 2009 from 3% in China or Canada, 7-9% in Russia, France or Portugal to over 10-15% in the USA, UK or Ireland, it becomes clear how the problem evolves (Ibid.). Generally, the public expenditures grew dramatically through the twentieth century, especially in the second half of it, under the influence of the economic policy of social insurance. It is necessary to understand, though, that any economic policy has to take into account certain theoretical considerations. Therefore, the growth of the public expenditures has to do with the implementation of the Keynesian economic thought. That is why it is normally recommended to develop economic policy on the basis of the theoretical models.

Ironically enough, one of the leaders of the classical British economic school John Stewart Mill inspired theoretically many socialists to create proposals that, eventually, in practical terms lead into the present situation (Skousen Ibid., p. 20). Based on the thesis that it is possible to distinct laws of production from the laws of distribution one may create a wide set of measures of the state interference with the principles of the market economy and thus shape any task for the state institutions. In other words, governments venture into the production of different public goods. At the same time, the issue of the budget deficit can be studied from the point of view of the influence of the special interest groups on the lawmakers. Through such a rent-seeking interaction expensive legislation for the tax payers to pay for gets put together and hence essentially affects public finances (Gwartney and Stroup 1996, p. 79).

Regardless of whether a certain theoretical model is implemented this or that way, or whether we like or dislike the outcome, unless economic science has practical relevance it is questionable how useful it may be to improve society which is the goal humans stream to. Ivory tower abstracted theoretical models will not help the ultimate purpose of the scientific economic analysis.

At the same time, in today's economic crisis circumstances the level of the public debt becomes unbearable burden on the back of the economic systems of the developed countries<sup>2</sup>. Maneuvering space to pursue eco-

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<sup>2</sup> Troubles that befell Greece, while some other countries may be faced with the same is what stimulates debate on the introduction of the European Monetary Fund in some form. Such a fund would help EU find solutions for the public finances sort of problems without turning to the IMF, which is less realistic option for the time being. The concept was

conomic policy in the circumstance of very high public expenditures and public debt has significantly gotten narrower since the Great Depression of 30ies of the 20th century. Such course of events suggests that measures to prop up the economy are shortsighted unless one sheds more light over the problem of the structural misbalance in the economic system of the western world<sup>3</sup>. High quality standard of living, in comparison to other parts of the world, has influenced redistribution of priorities within those societies (in the European countries before all). More welfare state, but smaller growth rates. That so called tolerant growth<sup>4</sup> has masked ever bigger structural problems which have appeared and grown over time only to rise in full in time of the recession. Different societies react differently to the certain extent, but the assortment of measures and general policies is more or less determined and heads to the structural dead-end.

Whichever road taken, sooner or later one realises that the problem is to address issues that are imposed by the evolution of capitalism in its fight to resist upcoming challenges over time. The costs of the social insurance (pension system, health insurance system or other segments) and the costs of education dominate total budget expenses. Over the long haul without adequate response the weight of the burden will only grow. On the other hand it is realistic to expect that further harmonization of the economic systems of the developing countries and developed countries will take place. Developed countries will face the challenge of reshaping their failed welfare states (especially European ones), while the developing ones will look at the possibilities to expand social security as it has been deemed a standard in the modern civilization.

Without savings and capital investments there is no increase of production in the long term. Shifting focus from those values towards consumption releases the vicious circle. On the other hand, one must not forget that economy is the science that studies ways to satisfy human needs. Contrary to the land and labour two out of three fundamental factors of production which easily get converted into other forms, once engaged capital finds it difficult to shift into other combination of resources. Time preference of consumption (which has direct impact over interest rates) is the key to understand business cycle according to the Austrian business cycle theory. That theory seems to be most consistent one among all generated up to now and it is possible to use it to explain the actual crisis as the consequence of the dynamic growth of

presented by Daniel Gros and Thomas Mayer in their article on the Disciplinary Measures *The Economist* Feb 20th 2010.

<sup>3</sup> For instance one can take a look at the health spending that hits about 9% and growing in the OECD countries, while the expected life span after retirement in the OECD countries is almost 20 years for men and over 20 years for women. That underpins debate on further pension reforms in terms of rising the retirement threshold. *A Slow Burning Fuse*, *The Economist*, June 27th 2009.

<sup>4</sup> Tolerant growth is used as a goal by the politicians in the developed countries. The term was coined by Colombatto and Macey in their paper on the Information and Transaction Costs as the Determinants of Tolerable Growth Levels, Working Papers, ICER, 1998.

all the sorts of assets over long period of time. It was merely a matter of time when that bubble was supposed to burst.

Applying the Bohm Bawerk's theory of capital and interest rates, Mises and Hayek defined the principles of the Austrian business cycle theory. State intervention on the supply side of money, or reduction of the interest rates below so called Wicksell's „natural“ one inevitably affects production to move to those goods it takes longer time to produce. In the contemporary economics dictionary words, bursting bubble helped everyone realise the wrong allocation of resources<sup>5</sup>.

Business cycle gets importance when the whole social context is analysed. In times of expansion the need to redistribute grows which inevitably reduces level of the economic freedom and consequently reduces the progress rate of an economy, which suggests there be the need to reform in order to move the cycle once again.

#### 4. Montenegro: A Case Study

Austrian school theory of business cycle offers useful explanation for the analysis of the crisis in Montenegro. Undoubtedly, world financial and economic crisis underpins the negative trends. Lack of liquidity, fall in consumption and revealing of bad investment decisions it all spilled over to the Montenegrin economy in a similar way. For the analysis' sake it is useful to take a look over the trends in the Montenegrin banking-monetary system in the past several years. Simple analysis of data collected by the central bank suggests dramatic increase of the money supply in the period preceding the crisis, as well as much too rapid credit expansion particularly in 2007.

First, the analysis of monetary data on various aggregates shows their growth by each of them:<sup>6</sup>

In 000 euros

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

<sup>5</sup> The starting point of the Mises's theory of business cycle is BohmBawerk's theory of capital and interest, Wicksell's hypothesis on the „natural“ interest rate that tells of the natural savings rate in an economy and is different from the actual market one, as well as the Hume-Ricardo assumption there is no inflation in the long term under the gold standard system. Mark Skousen, *Vienna & Chicago Friends or Foes?*, Regnery Publishing Inc, Washington, 2005 pp. 168-169.

<sup>6</sup> Monetary agregat M0 is made of banks deposits with the CBCG and assessed amount of cash flowing. Monetary agregat M1 is made of M0, non banking sector sight deposits with banks and the CBCG in euros and other currencies excluding central governments deposits. Monetary agregat M11 is made of M1 plus central governments sight deposits in euros and other currencies. Monetary agregat M2 čis mede of M1 and time deposits of the nonbanking sector kept with the banks and the CBCG excluding central govtrments deposits. Monetary agregat M21 is made of M11 plus time deposits of the nonbanking sector including central governments deposits in euros and other currencies. Central Bank of Montenegro Annual report 2007.

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

Similarly, the same conclusion can be drawn by the analysis of the growth of credits (Ibid p. 61).

In 000 000 euros

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

It is obvious that the growth of credits is linked to the growth of deposits. By saying that, one should bear in mind significant changes in the structure of deposits that took place between 2003 and 2007. While the relationship between businesses and population deposits was 91 to 45,1 million euros in 2003, in 2007 it was 663,5 to 1,019,3 million euros in favour of population deposits. At the same time, corporate loans, though converging to retail loans, is still stronger component in total loans structure. Back in 2003 it was 126,6 to 49,9 while in 2007 it was 1,364,4 to 795 million euros. It is worthwhile noticing that the vast majority of loans get covered by deposits. However, it is also worthwhile noticing that long term loans coverage with long term deposits stood at only 42% in 2007 (Ibid., p. 28).

For the sake of analysis adjusted to this paper, it is necessary to figure out interest rates trends for specific sectors. The trend of interest rates reduction is evident in the period 2005-2007. Generally both average pondered nominal and effective interest rates took the falling tendency throughout the economy and various industries. As a consequence of the credit expansion in 2006 and 2007 the process quickened, albeit at different speed in some sectors (Ibid., p. 66).

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

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

Between 2005-2007, interest rates fell sharply, and in virtually all the sectors of the economy. In particular, it is interesting to take note of a strong decline in the interest rate related to the sector of construction and housing. It obviously corresponds to the ever bigger amount of work in the related period. The drop in the interest

rates implies that banks were stimulating this activity, too. Similarly, the same accounts for the production industries, while as a contrast after a sharp decline in the fields of tourism and services in the observed period there was a reverse trend in 2007. From the amount of loans point of view, the retail (population is still the net creditor) participated with 35,15% and it was followed by trade which held 26,1%. Construction and housing along with the sector of services and tourism were far ahead of other industries with 9,03% and 8,63% participation rate respectively. Areas of transport and storage business as well as real estate trade saw biggest rise at the end of 2007 with the participation rate of 3,55% and 3,56%, respectively.

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

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

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

## 5. The market process

David Landes has put that economics is a discipline that would be science and therefore would be up to

date, and yet is always rediscovering the yesterday's news without realizing that (Landes 1999, p. 194). The current crisis may imply to the Austrian theory of the business cycle, but could also turn more attention to the market process theory.

The market process approach is the basics of the contemporary Austrian school of economic thought. It has developed since Mises and Hayek first added new principles to enrich the Austrian approach into the blazing intellectual debate which took place back in the 20ties over the economic calculation issue<sup>7</sup>. On the uncertainty that characterises the context in which individuals make decisions and on the problem of the unawareness of the lack of knowledge which is followed by surprise once discovered one may develop thesis that can be wrapped up in the market process school.

When all of us make certain decisions we normally do it against the pieces of information we have. As we do it we take into account actual state of affairs that is our attitudes, convictions, preferences. On the other hand, present circumstances are also characterised by available technologies, and related to that, available resources. Induced values – prices, quality of products and so on – are the outcome of the combination of existing characteristics. Coincidentally, by making our decision we project preferred future outcome which is to be compared with the real one when happens. In that way a new cycle gets kicked off, and an observed individual uses new knowledge or experience that may cause the change of preferences or convictions. Additionally it may cause the change of technology too, bringing in new dynamism and moving the system away from the equilibrium. In case we are unsure of the quality of a decision we are about to make based on the information we have, we will continue to search for the additional pieces we believe are relevant. At the certain point in time, however, we still make decisions.

However, that sort of ignorance is not the key ignorance that at the certain moment affects the market equilibrium, either towards or away of it. The very knowledge we come to totally incidentally (as though someone turns on lights in a room, and we did not know it was possible at all, that helps us realise many new things) can turn upside down our future behaviour and influence market forces to move towards or away from equilibrium. Normally it is related to the surprise. The ground assumption is in fact that the market is in a sort of a dynamic disequilibrium – contrary to the usual neoclassical interpretation of the equilibrium model. It is entrepreneurs who by taking note of a new chance work to turn

them into a profit opportunity. Of course, in their venture they can either succeed or fail. That is exactly what makes them play the key role in the economic system bringing dynamism and development.

When the market process model is implemented to explain the real world, it becomes evident why state interference is doomed to fail. State, that is its bureaucrats, can never resolve properly neither the basic problem of knowledge not the advanced one. Regardless of the invested efforts to search for the best solution constant change makes visible hand artificial approach obsolete on the first day of implementation. Secondly, and more importantly, state cannot resolve the lack of awareness of the knowledge problem which once encountered suggests the possibility of already wasted tax payers' money or the misallocation of resources (Ibid., pp. 157-159).

It is possible to assess the quality of institutions from the market process point of view, too. The question is whether the existing institutions contribute to meet the needs of the individuals, how valuable they are in increasing our utility, and how much they contribute in discovering chances that underpin the overall development (Ibid., pp. 180-192). From the economics angle, it is only those institutions that promote private property and economic freedoms which in the true meaning of that word can enhance the society's wealth. At that point, however, we tend to collide with the issue of legitimacy of certain institutions of a society. As usually egalitarian principles tend to prevail (welfare state models tend to possess high legitimacy regardless of their economic unsustainability), the question is how can one help sustain institutions that promote economic freedoms? Colombatto contends that though institutions do not necessarily affect individual preferences, ideas and ideology do. Should institutions function against that perception society may start to crack, loses its cohesion and risks revolt and uprising.

All the same, it is a delusion if we believe in the „market failure“. That very failure in fact does not exist. The market is but a mere reflection in a mirror of the decisions we all make. The question of why the outcome is what it is? In a situation in which governments spend half of their GDPs it is hypocritical to put blame on markets for the outcome as if it was an alienated being on its own. Therefore, the economic system and the economic science can not be isolated one from the other if we are to implement basic principle of how feasible theoretical recommendations are in practice. It is pretty straightforward to conclude that the classical or Austrian school of economics principles are difficult to be rebuked as the implementation of those principles in practice leads society to the higher level of economic efficiency (in the enough a long term overall wealth too). However, if fully consistently applied it may be a cause of a trouble and social conflicts. In the best case, one may expect the process of evolution to take place to harmonise existing social models. This is because in dealing with social issues sheer profit approach that kicks off market forces cannot be applied as the implementation of the superior set of insti-

<sup>7</sup> Old Austrian tradition knew of the following principles: methodological individualism, methodological subjectivism, marginalism, relationship between utility and demand, opportunity cost and time structure of consumption. Mises and Hayek battled vivid intellectual debate over the issue of the economic calculation in socialism in 20ties. The theoretical implication of that debate were two new principles which made difference between the Austrian school of thought and other subjectivistic schools. Those principles were that individuals make their decision in a context of uncertainty and that the market process means systematic discovery of chances that is linked with the surprise factor (Kirzner 1992).

tutions depends on our expectations that all individuals will apply the newly discovered and more efficient rules.

To that end there appears a logical question related to the quality of data that helps us draw conclusions on what happens in a society and to compare those results with other countries. Dissatisfaction with widely used aggregate such as GDP is growing. On the other hand, important advantage of the GDP is that it is a single tool that enables as simple as possible economic analysis of very complex interrelationships between economic agents. Statistically speaking, GDP by showing direction in which an economy heads to manages to reconcile nicely different approaches of the classical, neoclassical and Keynesian economic thoughts. However, it does not provide with the answer to the key puzzle – am I as an individual happy with what is going on in the economy I belong to. For the same reason, it is the quality of the economic freedoms indicator that is also put to the test as the chief conclusions are derived on the basis of how GDP and GDP per capita perform in the observed countries. Nevertheless some indicators suggest high GDP per capita in some countries it is still an open issue would that be enough for us to decide to move to live there supposedly it is an easy decision to make. With the same level of the GDP for example, the higher standard of living might mean the cleaner environment, or lot less time wasted commuting per day. Put differently, there is a leeway for the GDP per capita to fall as long as some other indicators perform better which keeps us equally rich.

Actually, the question that moves things back to the beginning is whether the implementation of that model from the macroeconomic indicators point of view (at the end of the day GDP per capita is still a derived macroeconomic indicator) is acceptable and applicable the same way in other societies. Manifested throughout the market process it is the very decisions that individuals who as part of a community take that often stem from their preferences that get developed on the basis of beliefs, tradition or habits. What macroeconomic indicators hide is the relationship between informal and formal rules in one society. The distinction gets more acute as one attempts to implement the set of formal rules that has arisen from a cultural matrix of one society into another with completely different tradition and habits<sup>8</sup>. To that point, one has to differentiate situation in which formal rules collide with the informal ones which in turn threatens systemic or cultural shock from a situation which is characterised by bad formal rules which need to be changed (Colombatto 2009, p. 42). For the argument's sake, it is often said that the phenomenon of corruption arises from the intention to implement fairly complex EU legislation in countries that are characterised by different behaviour rules, but it may arise from the bad legislation one country has too. Potential solution might be the

implementation of the EU legislation with as few as possible procedural steps, barriers or institutions which preemptively affect dominance of the informal rules and therefore help sustain cultural transition.

One of the most recent researches that have pinpointed its goal in the quest for the more realistic indicators of how one society and its economy perform has been done by the commission led by Joseph E. Stiglitz, Amartya Sen, and Jean Paul Fitoussi<sup>9</sup>. Though their scientific background is (post)Keynesian with the purpose to emphasise importance of the public goods and services provided by the state, findings of this commission put new light over usefulness and comparability of the traditional aggregates from the wellbeing of each individual. At the same time, it is difficult to ignore the role of households and their disposable income which appear to be a lot more relevant indicator to be measured and analysed than many other. It is necessary, however, to organise a set of adequate researches in order to draw conclusions on the potentials of the welfare of a society.

## 6. New general theory?

On the one hand, the market process model very consistently explains the way market forces function in light of decisions that individuals make. The outcome of how those forces operate can more or less be distorted by the government's action which may cause essential changes of the underlying values and that in turn moves equilibrating forces that generate creation of new induced values. From that point of view the transition process that other ex-socialist countries underwent could be taken as a special case. On the other hand, a human person belongs to society and adjusts its numerous decisions to that notion, as those decisions are reflection of the tradition or habits that characterise certain society. More concretely, most of the decisions taken have previously been either debated or negotiated within the family a person belongs to, as phenomenon of the propensity to spend or save are directly related to households. This particularly gains importance if one accepts conclusion that economic

<sup>8</sup> Stiv Pejović, Why is Culture Important?, *Preduzetnička ekonomija*, Vol 2, Podgorica, 2003. according to Pejovic the higher the cost of the transition process and the less efficient economic exchange the more acute collision between formal and informal rules – the interaction thesis.

<sup>9</sup> Joseph E. Stiglitz, Amartya Sen, Jean Paul Fitoussi, Report by the Commission on the Measurement of Economic Performance and Social Progress, [www.stiglitz-sen-fitoussi.fr](http://www.stiglitz-sen-fitoussi.fr) there are 12 recommendations in the related report: when the material wealth is evaluated one needs to focus on income and spending, rather than production; it is necessary to take households perspective; give more importance to the income distribution, spending and wealth; expand the level of income analysis to non-market activities; quality of life depends on objective circumstances which makes it necessary to improve measurement of human health, education, hobbies, environment; indicators of the quality of life in the observed areas are to encompass inequalities appropriately; researches are to be conducted so it enables one to assess links between different domains of life quality for each individual; statistic offices should provide information in order to devise indexes necessary to consider life quality in different aspects; research should supply measures of both subjective and objective wealth assessments; sustainability analysis should supply with quality set of indicators; environmental sustainability deserves separate set of physical indicators. Regardless of quality and scientific background of reports it is questionable how practical those reports can be, and how realistic it is to conduct adequate research on the basis of outlined recommendations.

analysis can explain individual decision making process but cannot explain group decision making<sup>10</sup>. Schumpeter was particularly concerned about the future of capitalism as he had noticed the action of forces that disintegrate families as according to him the chief reason for households to save, or accumulate capital is to meet the need of providing for the security to one's family (Ibid. p. 162). Therefore, it is a logical effort to identify trends that explain how a society as a whole develops and to that end design policies that aim at providing for good trends to last long. Also, should one align with Schumpeter's assessment in relation to the human need to provide its family with security then legitimacy people grant to many welfare models programmes becomes understandable. Especially if one takes into account that there is 3-5% of entrepreneurs in each society who are ready to respond to challenges ahead on the basis of personal responsibility.

An interesting analogy can be found in the physics and laws that depict nature. By comparing micro aspect with the moving of a particle, that is with the quantum mechanics and macroeconomic aspect with the general relativity theory we will come to many answers. However, physicists continue their quest for the final response (Hawking 2002, p. 26). The principle of uncertainty applied to the economics suggests the uncertainty context in which we make decisions, but also the uncertainty of decisions themselves. Entrepreneurship influences our behaviour by having an impact on the way we adjust our decisions in different time intervals to new circumstances. That is why microeconomic values such as saving, investment in knowledge and capital goods define dynamism of any economy. On the other hand, welfare economics has ambition to create policies that will improve the whole society. The outcome, however, cannot be an equilibrium model, as it directly collides with the need of humans to acquire new knowledge<sup>11</sup>.

That is why splitting micro from macro aspect is not a sustainable scenario as it leaves behind a huge unresolved void. Neither economic school, nevertheless one personally inclines to it or not, has provided for the final answer. Unless there is a new synthesis of knowledge. That is why the author of this paper thinks it is impossible to isolate economic theory from the general society theory. To Adam Smith the invisible hand was most likely the divine hand that managed to make people harmonise their interests within the moral system they belong to which is the result of behavioural evolution in a society (Skousen 2005 p. 254). It is not possible to ignore sociological and religious aspect. At the same time, the globalisation process enables to harmonise different patterns of behaviour. If the world manages to avoid clash of civilisations (Huntington 2000), it is realistic to expect a gradual evolution towards making a global set of values in the next decades that could reaffirm position of an individual

and a family/household, that is uncertainty principle and dynamics on the one hand and the need of humans to rely upon collective institutions in order to reduce poverty, improve health and education on the other. That could make grounds for the new general theory, under the assumption one does not neglect that collective institutions cannot resolve the problem of unawareness of the lack of knowledge and the role of entrepreneurs in resolving it. It may help redefine the role of state and rediscover its limits, while enabling institutions stimulate the discovery process and the entrepreneurial instinct in the markets.

## 7. Concluding remarks

The course of the financial and economic crisis can be studied through the Austrian school of economics lens. The theory on the business cycle could be applied to provide one with the explanation why and in what way a crisis is inevitable in case the supply of money grows faster than the economy productivity. The example of Montenegro might be used to apply the theory thesis. On the other hand, in mid to long term the only way to mend one economy way is through the structural agenda – labour market and social safety net reforms along with the agenda to trim the bureaucracy influence. Fiscal and monetary stimulation policy are there only to bridge the gap to the sustainable policies as suggested by the EU member states challenges. The welfare state model undergoes profound identity check-out. From the Austrian school angle the proper response is to establish the institutional framework which is favourable to the market chances discovery process. That process stimulates entrepreneurial energy which is essential to the economic development. At the same time, many a state function does not lose legitimacy in the society. Putting forward an efficient, flexible as well as functional economic policy assumes taking into a consideration all sorts of risk related to quick changes in the environment. It assumes also the implementation of a selected and well balanced pluralism of the economic findings and different economic paradigms, and especially those that have proven viable in practice. By reaffirming the Austrian business cycle theory and the need to revisit the boundaries of the state's interference into the economy it seems that economics need new energy of thought to invent a new general economics theory.

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<sup>10</sup> This conclusion was drawn by Keneth Arrow. Steven Pressman, *Fifty Major Economists*, Routledge London and New York, p. 269

<sup>11</sup> Statics and equilibrium go against the cosmic order. It was not so though before the 20th century when people had thought the Universe was static and unchangeable, Ibid., p.19.



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### Zaključak

*Tok finansijske i ekonomske krize je moguće analizirati iz ugla austrijske ekonomske škole. Primjenom teorije o biznis ciklusima dobija se objašnjenje zašto i na koji način dolazi do krize, kada ponuda novca raste brže od produktivnosti ekonomije. Primjer Crne Gore je aktuelan za primjenu teorije biznis ciklusa. S druge strane, u srednjem i dugom roku jedini način da se otklone ekonomski debalansi je kroz agendu strukturnih reformi – reforme tržišta rada, sistema socijalnog osiguranja, kao i ukidanjem pretjerano birokratizovanih procedura. Fiskalna i monetarna politika stimulatornih paketa samo mogu premostiti problem u kratkom roku kao što pokazuju problemi zemalja EU. Model države blagostanja prolazi kroz duboku krizu identiteta. Iz ugla austrijske teorijske osnove odgovor na problem je uspostavljanje institucionalnog okvira, koji podstiče proces otkrivanja šansi na tržištu, jer je to put u podsticanje preduzetničke energije, koja je esencijalna za ekonomski razvoj. Istovremeno, mnoge državne funkcije ne gube legitimitet u društvu. Izgradnja efikasne, fleksibilne i funkcionalne ekonomske politike podrazumijeva uvažavanje svih vrsta rizika, vezanih za brze promjene u okruženju, selektovani i izbalansirani pluralizam ekonomskih instituta i primjenu racionalnih preporuka raznih ekonomskih teorija, a posebno onih postulata koji su se pokazali održivim u praksi razvijenih privreda. Reafirmacija austrijske teorije biznis ciklusa kao i potreba preispitivanja granica državnog uplitanja u ekonomiji utiču na potrebu da ekonomska nauka nađe novu energiju misli u cilju kreiranja nove opšte ekonomske teorije.*