



Finance-dominated capitalism in crisis – the case for a Keynesian New Deal at the European and the global level

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1.

Introduction

- Present financial and economic crisis (2007 – 2010?) marks a structural break in long-run development since the early 1980s
- Neoliberal model of deregulated labour markets, reduction of government intervention and social policies, redistribution of income from (lower) wages to profits and high management salaries, and deregulated financial markets is exhausted in terms of generating high growth and high employment

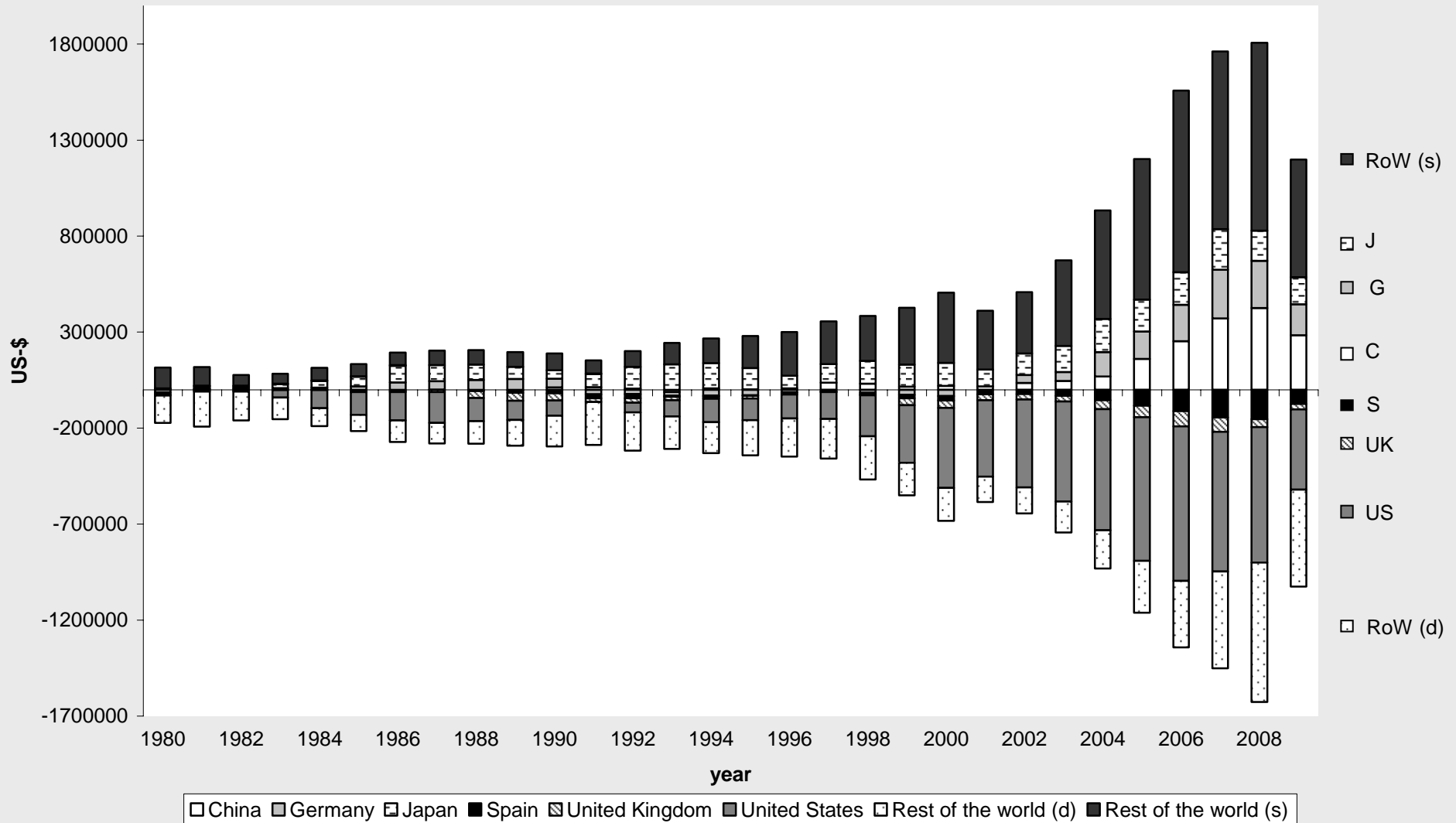
- **Main sources of present crisis:**
 - inefficient regulation (of financial markets in particular)
 - inequalities in income distribution (personal and functional)
 - imbalances (of current accounts) at the global level and within Euro area
- **Short-run prevention of a financial melt-down and a currency crisis (euro), and counter-cyclical policies macroeconomic policies, have to be supplemented by**
 - re-regulation of financial markets,
 - re-orientation of macroeconomic policies
 - re-construction of international policy co-ordination and world financial order

1. Introduction
2. Long-run inequalities and imbalances of finance-dominated capitalism and the present crisis
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5. Conclusions

2.

**Long-run inequalities and imbalances of
finance-dominated capitalism and the
present crisis**

Figure 1: Current account balances, 1980 – 2009, in millions US-\$



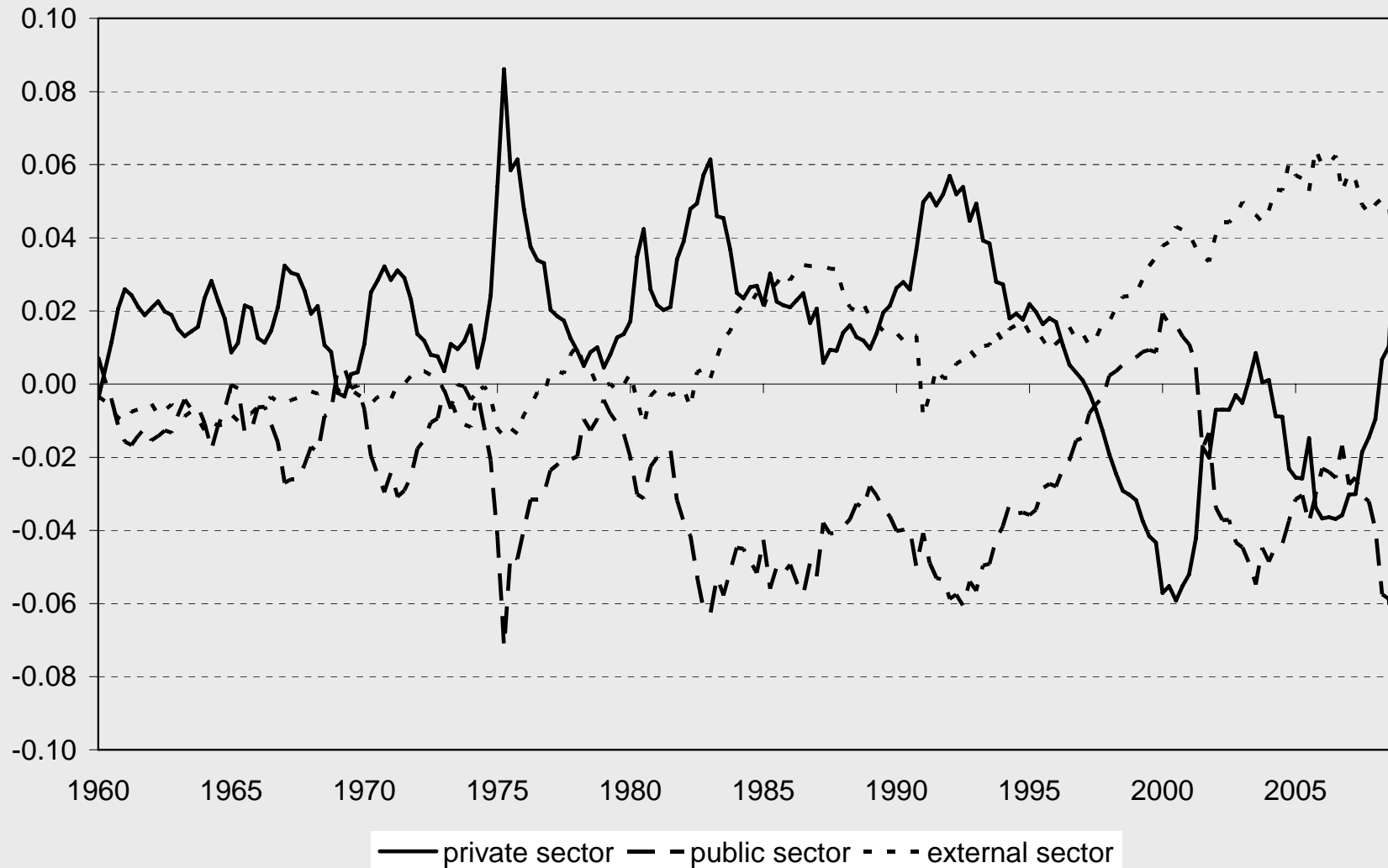
Source: IMF World Economic Outlook Database, authors' calculations.

➔ US and Germany as two main representatives of world imbalances ...

2.1 Financialisation and unstable debt-led private consumption boom in the US

- falling labour income share and increasing inequality in households' income
- 'profits without investment' regime (van Treeck/Hein/Dünhaupt 2007)
 - weak private investment (shareholder value orientation, dividend payments and share buybacks) and negative current account (over-valued US\$) have been over-compensated by private consumption
 - with stagnating wages, increasing consumption required decreasing propensities to save out of labour and rentiers' income
 - increasing household indebtedness (seemingly) backed by collateral generated by asset price and house price bubbles and made possible by financial innovations (credit card debt, securitisation, 'originate + distribute')
- highly fragile constellation, which had to rely on rising property prices and households' willingness to go into debt and prevention of sharp depreciation of US\$

Figure 6: Financial balances as a share of nominal GDP, USA, 1960-2008



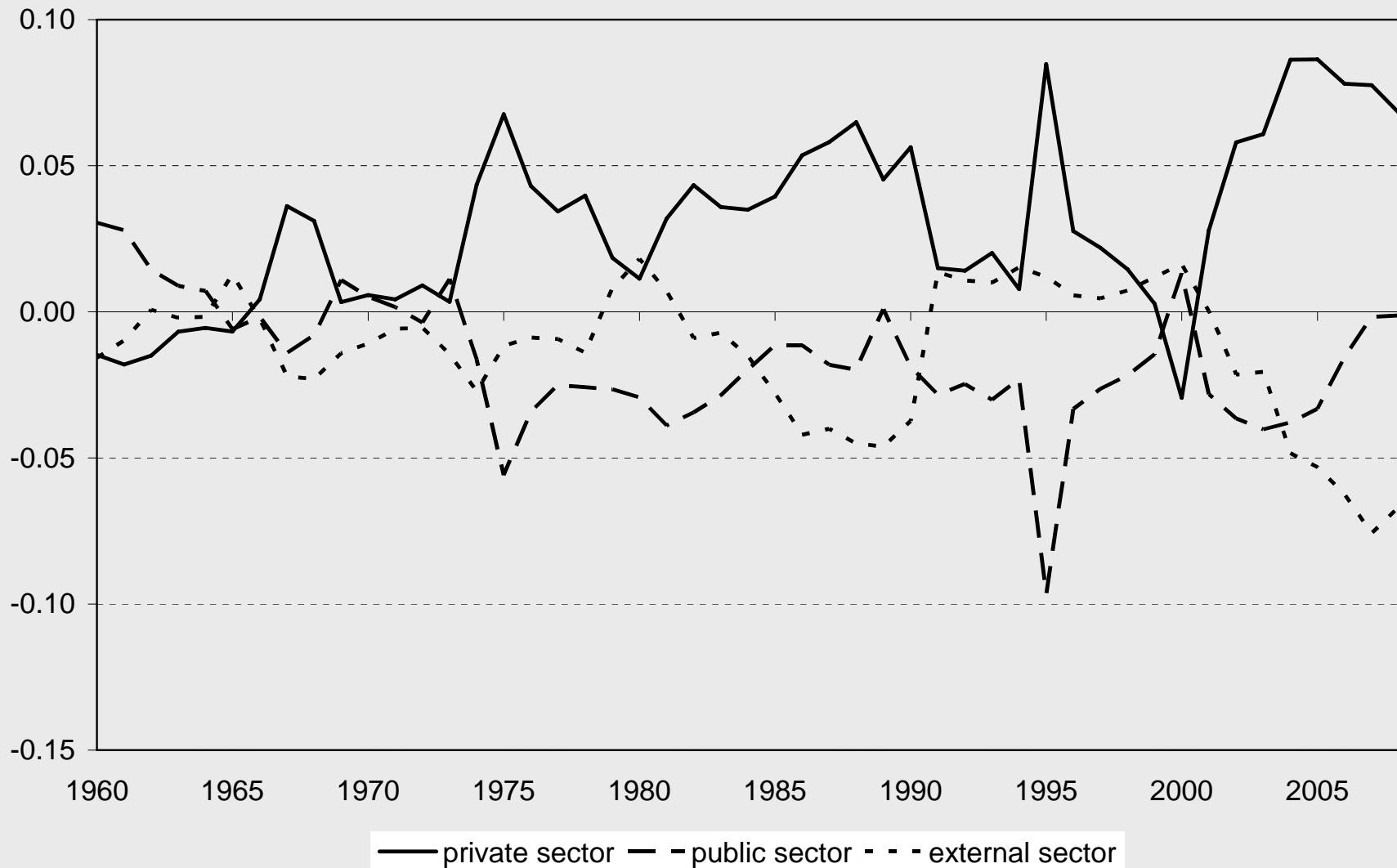
Source: NIPA, tables 5.1, 1.1.5; authors' calculations.

➔ Unsustainable trends of financial balances and rising fragility in the US since the early 2000s

2.2.1 Dysfunctional mercantilism in Germany - a counterpart to the US development (together with China + Japan)

- falling labour income share, rising inequality in household incomes (Bach/Corneo/Steiner 2007, OECD 2008)
- 'profits without investment' regime
- due to restrictive macroeconomic policies
 - excessive wage moderation (Hein/Truger 2005, 2007, 2009)
- negative effects of 'financialisation' on investment since mid 1990s
 - 1991: stock exchange tax abandoned, 1998: legalisation of share buybacks, 2002: capital gains tax for corporations abandoned, 2004: legalisation of hedge funds
 - but no positive effects on consumption (no wealth effect)
- reliance on the export channel (EX/GDP: 24 percent in 2004, but 47.3 percent in 2008!, current account surplus peaked at 7.9 percent in 2007)
- highly fragile, because Germany's regime had to rely on growth of the world economy and increasing capital exports, i.e. on the willingness of the rest of the world to go into debt, with the risk of contagion in a financial market crisis

Figure 8: Financial balances as a share of nominal GDP, Germany, 1960-2008



Source: National Accounts of the German Statistical Office; authors' calculations.

➔ Unsustainable trends of financial balances and rising fragility in Germany since the early 2000s

2.2.2 Dysfunctional mercantilism in Germany as a contribution to the euro crisis

Euro area imbalances become apparent with Greek debt crisis in early 2010, threat of crisis also for Spain, Ireland, Portugal, Italy (?)

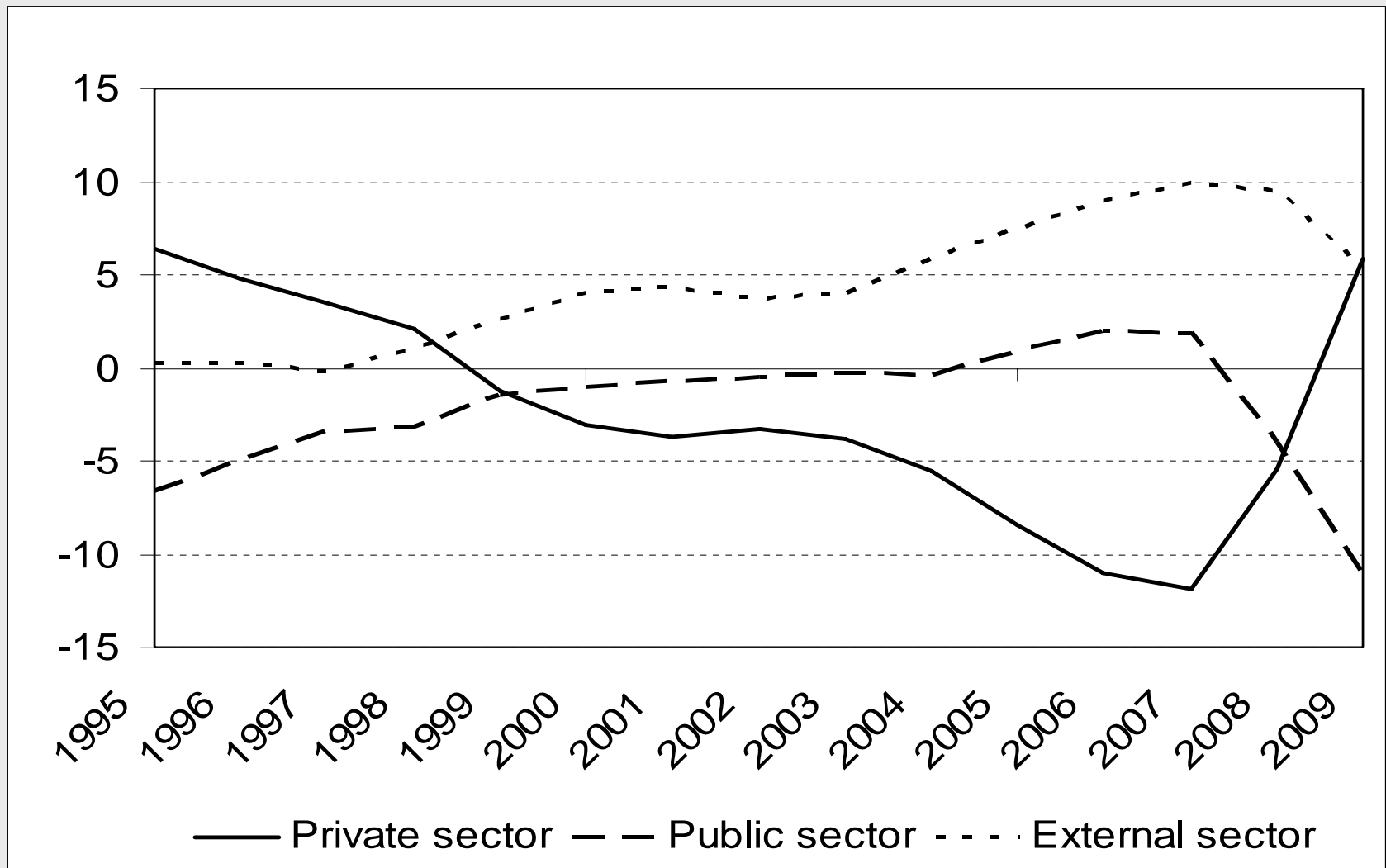
→ Mainstream view: markets discover unsustainable public deficits and public debt

→ Conclusion: tighter SGP in order to reduce and prevent public deficits and debt

But before the crisis, Spain and Ireland had budget surpluses and low debt/GDP ratios (2007: Spain: 36 %, Ireland: 25%)

→ Current account imbalances and deficits with the RoW as roots of the present crisis

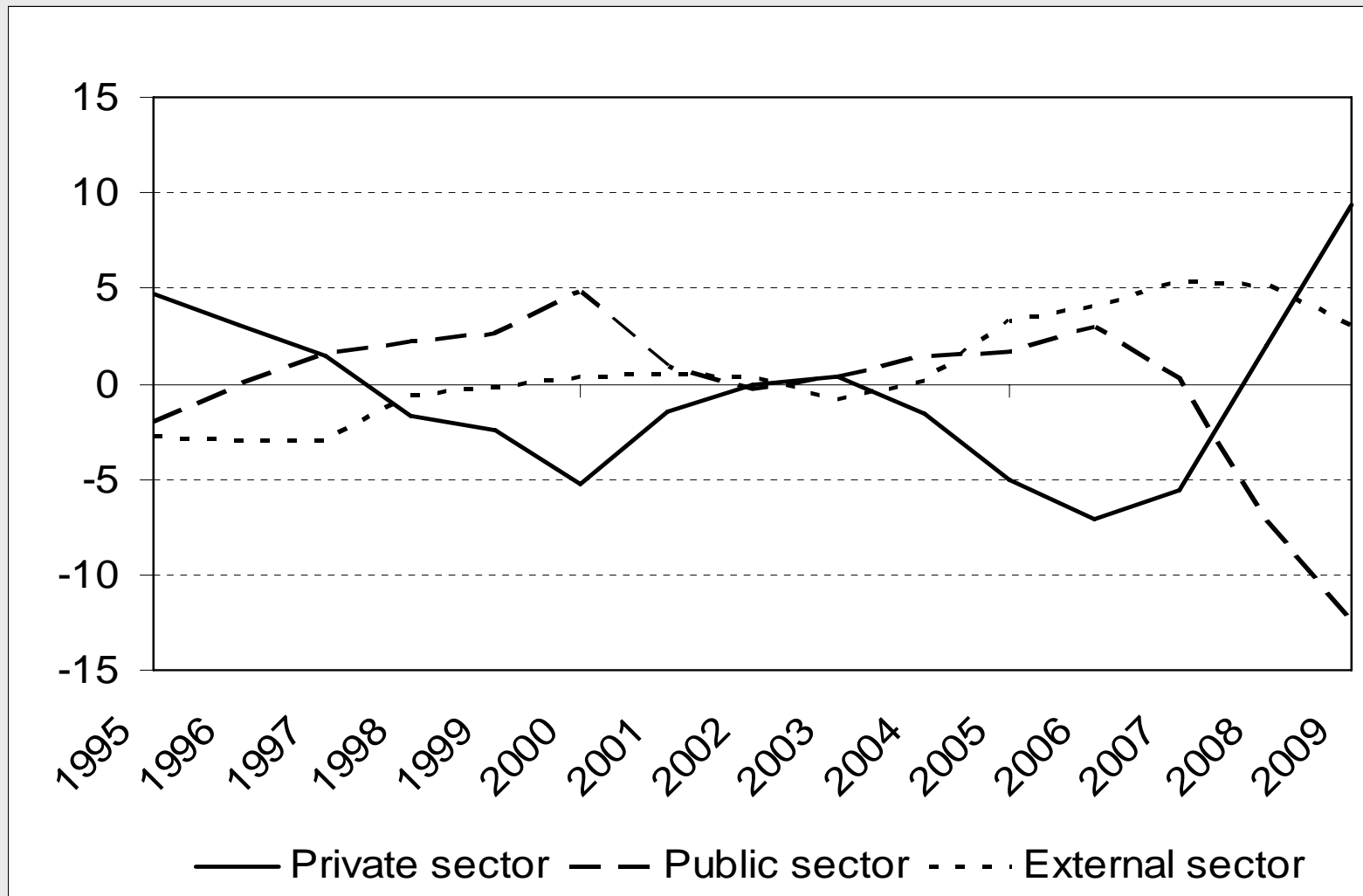
Figure 9: Financial balances as a share of nominal GDP, Spain, 1995 - 2009



Source: AMECO Database of European Commission, authors' calculations.

→ Spain: crisis turns huge private sector deficit into public sector deficit!

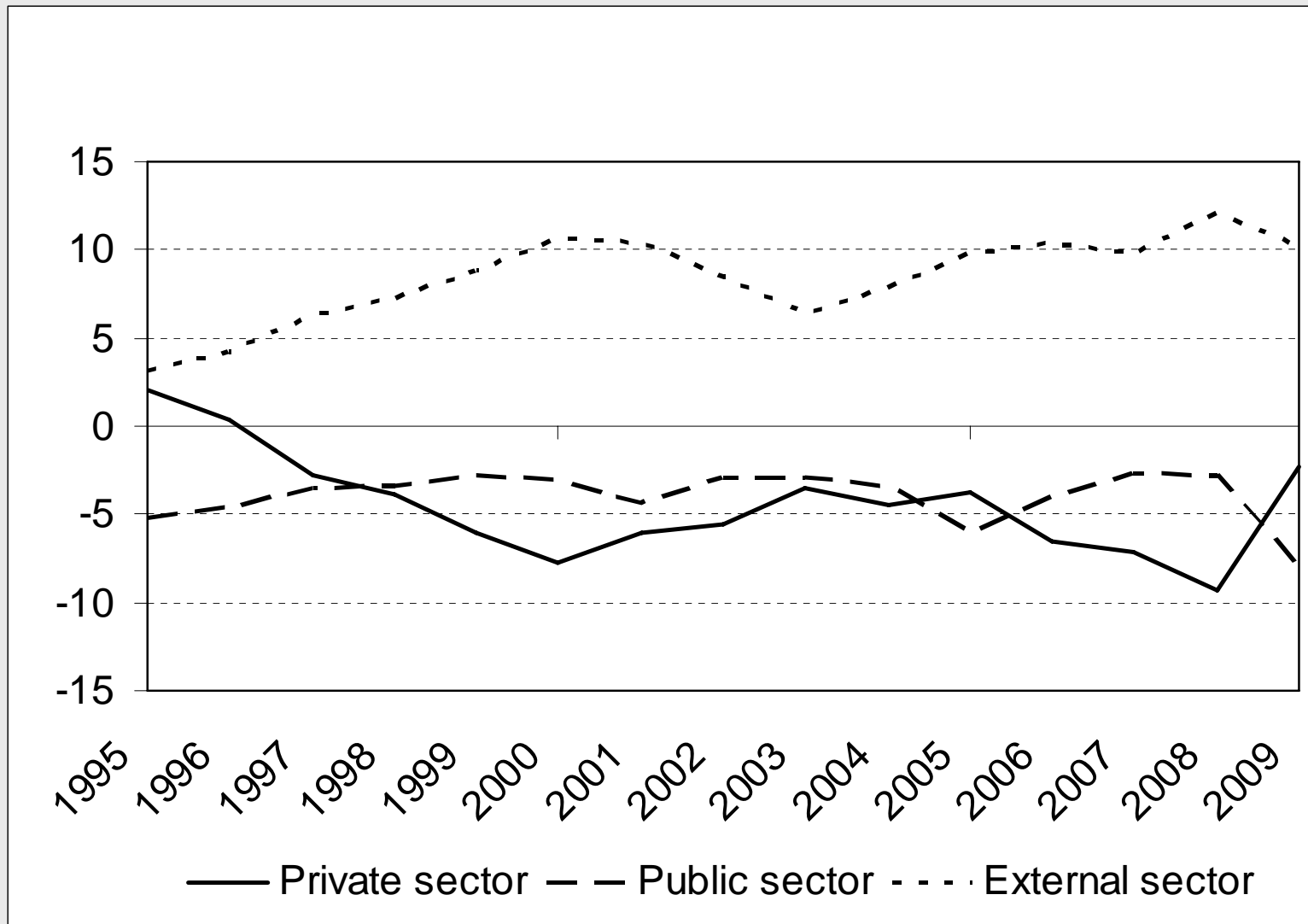
Figure 10: Financial balances as a share of nominal GDP, Ireland, 1995-2009



Source: AMECO Database of European Commission, authors' calculations.

➔ Ireland: crisis turns huge private sector deficit into public sector deficit!

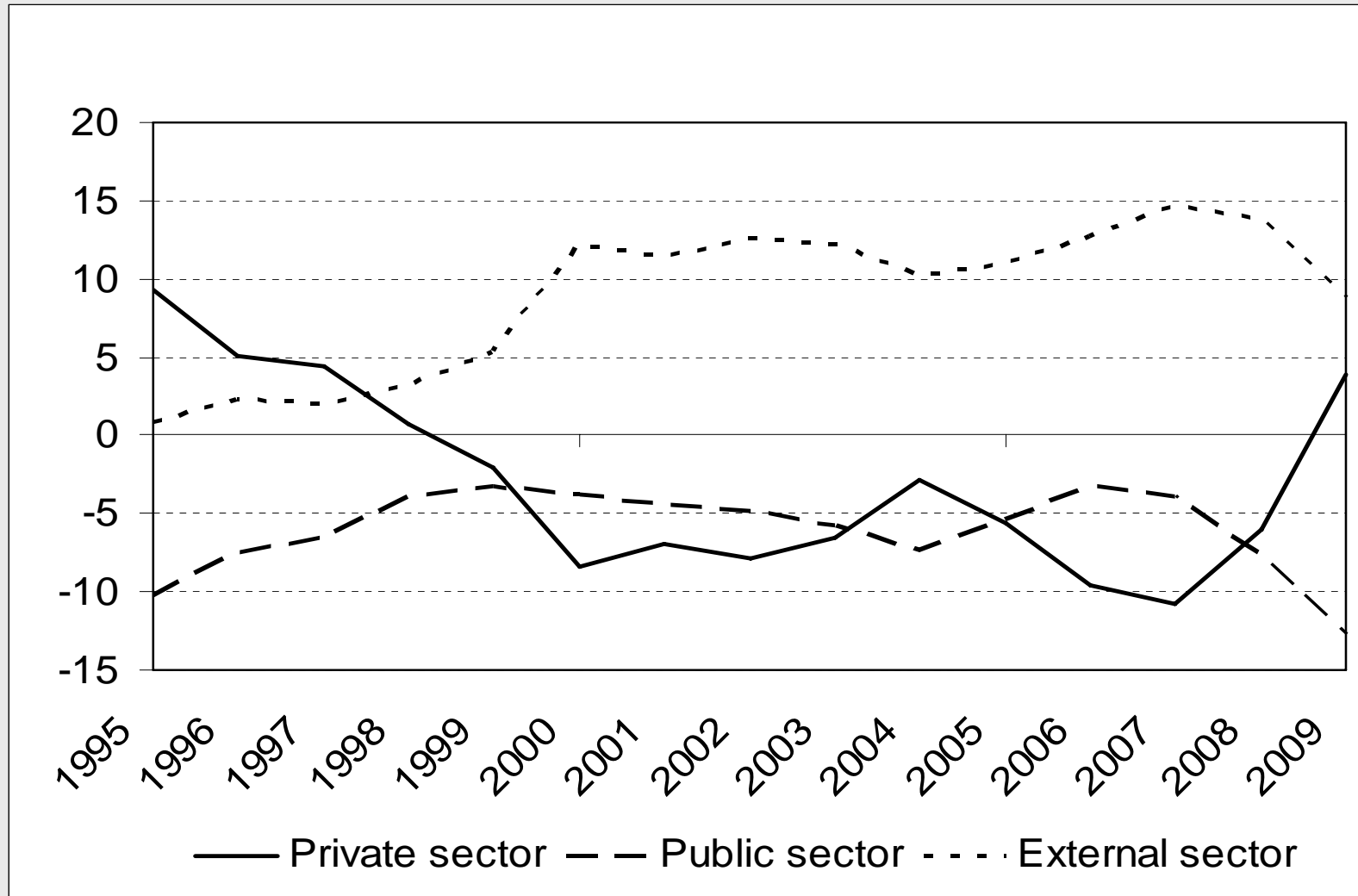
Figure 11: Financial balances as a share of nominal GDP, Portugal, 1995-2009



Source: AMECO Database of European Commission, authors' calculations.

➔ Portugal: in the crisis private sector deficit is reduced at the expense of public sector deficit

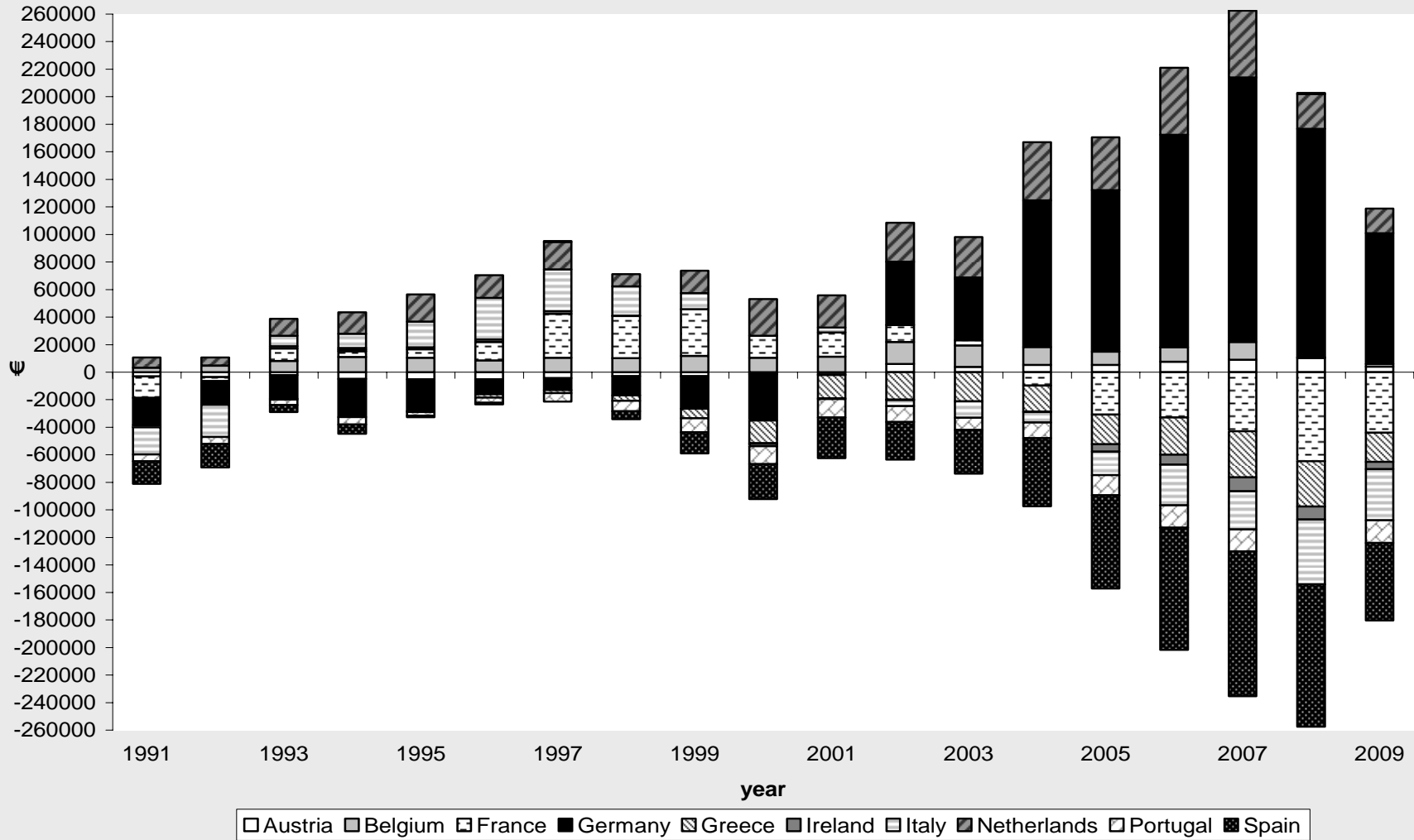
Figure 12: Financial balances as a share of nominal GDP, Greece, 1995-2009



Source: AMECO Database of European Commission, authors' calculations.

➔ Greece: in the crisis, private sector deficit is turned into surplus at the expense of public sector deficit

Figure 13: Current account in millions ECU/euro, selected Euro area countries, 1991 – 2009



Source: AMECO Database of European Commission, authors' calculations.

➔ Current account imbalances at the root of the euro crisis!

Table 1: Key macroeconomic indicators for imbalances, selected euro area countries,**1999 – 2007.**

	Austria	Belgium	Germany	Nether-lands	EU-12	Greece	Ireland	Italy	Portugal	Spain
GDP, average annual growth, in per cent	2.4	2.3	1.5	2.5	2.2	4.1	6.6	1.5	1.7	3.7
Domestic demand, average annual contribution to GDP growth, in percentage points	1.5	1.9	0.6	1.9	2.1	4.6	5.2	1.6	1.8	4.8
Balance of goods and services, average annual contribution to GDP growth, in percentage points	0.8	0.4	0.9	0.6	0.1	-0.5	1.5	-0.2	-0.1	-1.0
Nominal unit labour costs, average annual growth, in per cent	0.6	1.6	0.2	2.2	1.6	2.8	3.1	2.4	2.8	3.0
HICP, average annual growth, in per cent.	1.7	2.0	1.6	2.4	2.1	3.1	3.4	2.3	2.9	4.2
Current account balance, average, in per cent of GDP	1.4	4.4	2.9	6.8	0.4	-11.4	-1.5	-0.6	-9.2	-5.7
Balance of goods and services, average, in per cent of GDP	3.6	4.3	3.9	6.7	1.6	-11.2	13.7	0.6	-8.7	-3.8

Source: AMECO Database of European Commission, authors' calculations.

➔ Weak domestic demand and wage moderation in the low growth/low inflation surplus countries forces high growth/above average inflation countries into current account deficits

3.

**Economic policy reactions in the crisis and
perspectives for future development**

Stabilising the financial sector:

- provision of liquidity to money markets
 - central bank as lender of last resort
 - bail out of financial sector
- ➔ successful in the short run, long-run effectiveness and costs still uncertain

Macroeconomic policy reaction:

- Monetary policies: Fed: quick cut in interest rates; introduction of unconventional measures; ECB „wait and see“ and „too little, too late“, but finally drastic decrease in interest rates
- Fiscal policies: Massive anti-cyclical discretionary reaction in the US, less in Germany and Euro area, which now start to exit (Germany: debt brake)

Wage policies and unit labour cost growth:

- Weak trade unions plus rising unemployment in the US
 - ➔ negative nominal unit labour cost growth and deflationary pressure in 2010 ff.
- Stable employment in Germany but wage dumping since the late 1990s continues
 - ➔ negative unit labour cost growth in Germany and Euro area in 2010 ff.
 - ➔ as soon as expansionary fiscal policies are terminated risk of deflationary stagnation
- ➔ Germany and Euro area will not contribute to replacing US as world demand engine
- ➔ Imbalances within the Euro area will not be overcome
 - ➔ threat of implosion of the currency area will persist

4.

**Requirements for a Keynesian New Deal
at the global and the European level**

4.1 Re-regulation of the financial (and the real) sector

A. Increase transparency and reduce asymmetric information and uncertainty

- standardisation and supervision of all financial products,
- no off-balance sheet operations,
- national and international regulation and supervision of all financial intermediaries,
- independent public rating agencies instead of private ones,
- strong public and cooperative banks,
- public ownership of financial institutions with systemic importance.

B. Generate incentives for long-run growth

- limits on securitisation to prevent 'originate and distribute' strategies,
- reduction or abolition of share buy backs,
- reduction of stock option programmes for managers and minimum holding periods,
- extended co-determination and improved rights of other stakeholders.

C. Contain instability

- equity regulation for all financial intermediaries with counter-cyclical properties (Goodhart 2009),
- asset based reserve requirements for all financial intermediaries (Palley 2003, 2010),
- a general transaction tax for all financial transaction (Schulmeister et al. 2008) and a general capital gains tax.

4.2 Re-orientation of macroeconomic policies (Hein/Stockhammer 2009, 2010)

A. Monetary policy: low interest rates + supervision and regulation of the financial sector

- abstain from inflation targeting (fine tuning inflation and employment)
- asymmetric in short run and counter productive in the long run, because interest payments are costs which fuel conflict inflation
- policy of positive but low real interest rates ($i < g$), protection of rentiers' wealth, but redistribution in favour of productive sector favours investment
- lender of last resort + regulation and supervision of financial sector (ABRR)

B. Incomes and wage policies: nominal stabilisation + stable income shares

- nominal stabilisation (inflation consistent with balanced current account in Euroarea)
- nominal wage growth = productivity growth + inflation target
- stable wage share
- requires wage bargaining coordination, strong labour unions and employer associations, government involvement (minimum wage legislation)

C. Fiscal policy: real stabilisation in the short and the long run + redistribution

- real stabilisation, full employment, more equal distribution
- $G - T = S - I - (X - M)$ at long-run full employment (government investment)
- redistribution in favour of rentiers is prevented by $i < g$
- stabilise the economy in the face of shocks (automatic stabilisers + discretion)
- public debt stabilises financial markets (safe haven)
- progressive taxation (income + wealth) and social policies for income redistribution

4.3 Re-construction of international macroeconomic policy co-ordination, in particular on the European level, and a new world financial order

A. *Reform of European economic policy setting in favour of expansionary macroeconomic policies and overcoming the internal imbalances*

- Reform of ECB institutional setting + monetary policy strategy (towards Fed?) to force ECB to take into account long-run distribution, employment and growth effects, and set low interest rates, and to focus on financial stability (ABRR)
- Abandon SGP and replace it by coordination along functional finance (expenditure paths for non-cyclical government spending) + active coordinated counter-cyclical policies; on average over the cycle government deficits in each country should balance private sector surplus (or deficit); to overcome present imbalances countries with current account surpluses should increase government deficits
- Re-regulation of labour market, wage bargaining co-ordination (nominal wage growth = national average trend of productivity growth + inflation target), minimum wage legislation; to overcome present imbalances wages should grow above norm in surplus countries and below norm in deficit countries.
- Revive Macroeconomic Dialogue to improve ,ex ante‘ macroeconomic policy coordination in the Euro area

4.3 Re-construction of international macroeconomic policy co-ordination, in particular on the European level, and a new world financial order

B. New world financial order to tackle global imbalances

- fixed, but adjustable exchange rates,
 - symmetric adjustment obligations,
 - regulated capital flows
- ➔ Keynes's (1942): International Clearing Union
- ➔ UNCTAD (2009): managed exchange rates

5. Conclusions

- Severe global financial and economic crisis which is not yet over, difficulties to recover, in particular in Euro area, UK, Japan, ...
- structural break in long-run development
- Short-run stabilisation has so far prevented a global collapse
- danger of deflationary stagnation, in particular in Europe, and threat of implosion of the currency union due to internal imbalances in the medium run
- Global and European Keynesian New Deals are required which addresses the main causes for the severness of the crisis:
- inefficient regulation, increasing inequality and imbalances on the global and the European level
- Politically feasible?

THE END