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Short-run stabilisation policies won't do – the case for a Keynesian New Deal at the European and global level

by Eckhard Hein

The world economy is still struggling with its most severe crisis since the Great Depression of the late 1920s and 1930s. On the one hand, the present crisis began as a financial crisis which started with the collapse of the subprime mortgage market in the US in summer 2007, which then gained momentum with the breakdown of Lehman Brothers in September 2008 and reached another climax with the Euro crisis in early to mid 2010. On the other hand, the present crisis began as a real crisis well before the financial crisis, with an economic downswing in the US. The financial crisis and the real crisis reinforced each other, and the world economy was hit by a decline in real GDP in 2009 – something not seen for generations. Major regions in the world are only slowly recovering from this decline, in particular the Euro area, the UK and Japan. Furthermore, none of the economies which have been hit severely will have returned to the pre-crisis growth path by the end of 2010. Therefore, massive underutilisation of productive capacity, high unemployment and a downward pressure on wages will have to be tackled in the future.

Beyond inefficient regulation of financial markets, increasing inequalities in income distribution and rising current account imbalances at the global scale and within the Euro area are the main underlying causes for the severity of the global financial and economic crisis and for the recent euro crisis. The US and Germany are two important complementary examples of current account imbalances, the US being the major current account deficit country and Germany one of the important current account surplus countries.

The credit-financed consumption boom in the US prior to the crisis was highly fragile because it was set against a background of rising inequalities and a falling labour income share. Domestically the US had to rely on rising property prices in order to allow for increasing indebtedness to fuel steady increases in consumption demand. Regarding the relationship with the rest of the world, a sharp depreciation of the US-dollar, which would have been required in order to improve international price competitiveness of US producers and thus the current account, had to be avoided in order to guarantee steady capital imports without having to raise domestic interest rates. The erosion of such a constellation in the subprime mortgage crisis and the following downswing not only affected the US, but also the rest of the world, in particular the current account surplus countries. On the one hand, if their capital exports were into highly speculative US markets they were devalued by the financial crisis, and therefore the financial crisis quickly infected these surplus countries. On the other hand, the markets for exports collapsed and the current account surplus countries were thus infected by the real crisis as well.

While the dynamic consumption-driven model of the US had to rely on the willingness and the ability of private households to go into debt – and of the rest of the world to supply credit – the stagnating German neo-mercantilist model aiming at increasing net exports by means of wage moderation, in particular, had to rely on the willingness and the ability of the rest of the world to go into debt. This German model was thus as fragile as the US model. The moderate growth rates were dependent on the dynamic growth of export markets, while increasing capital exports carried the risk of contagion in the case of a financial crisis.

The German strategy was not only suboptimal for Germany; it has also been a major reason for the current account imbalances within the Euro area which are at the roots of the Euro crisis in 2010. Germany's consistently weak domestic demand growth, as well as its rising international competitiveness due to extremely moderate wage developments, has been a drag for other Euro area economies which had to accept negative current account balances, in some countries (Spain, Ireland) mainly associated with private sector deficits, in others (Greece, Portugal) also with public sector deficits. In the course of the crisis, public sector deficits and debts in these countries increased because of fiscal stabilisation, making liberalised financial markets speculate about the sustainability of this process. Of course, the housing price bubbles, particularly in Ireland and Spain, as well as too expansive fiscal policies and wage developments in the deficit countries have also contributed to the current account imbalances within the Euro area.

The breakdown of the world economy in the financial and economic crisis could finally be halted by monetary policy interventions providing liquidity on a massive scale and, in particular, by massive fiscal expenditure programmes. A collapse of the Euro area could be prevented in the short run by the intervention of the IMF in cooperation with the other Euro area countries bailing out Greece. However, due to the underlying imbalances, the world economy is unlikely to return to its pre-crisis growth path. In particular, the US will not be able to act as the driver of world demand any longer. The European

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Union or the Euro area are far from replacing the US as a world demand engine and rather suffer from their internal contradictions, mainly caused by the German neo-mercantilist economic policy strategy. Therefore, major parts of the world economy are presently threatened by a period of deflationary stagnation, high unemployment and pressure on wages; in particular when fiscal expansion comes to an end and governments attempt to reduce public deficits and debt. For the Euro area this will be accompanied by the threat of disintegration.

What is required in the present constellation in order to turn towards a sustainable growth path with (close to) full employment and to rescue the Euro area is a Keynesian New Deal at the European and the global level. The policy package of a Keynesian New Deal should address the three main causes of the severe crisis: inefficient regulation, increasing inequality in income distribution and imbalances at the global and the European scale. It should thus consist of three pillars:

(i) Re-regulation of the financial (and the real) sector. This includes measures, which increase transparency and reduce asymmetric information and thus uncertainty in financial markets, generate incentives for long-run growth, and contain systemic instability.

(ii) Re-orientation of macroeconomic policies along (post-) Keynesian lines. Monetary policies by central banks should target low real interest rates and should care for stability of the financial sector. Wage and incomes policies should take over responsibility for stable inflation rates and stable income shares, which implies that nominal wages should rise at a rate given by the sum of economy wide productivity growth trend plus the inflation target. Fiscal policies should take care of real stabilisation in the short and the long run and of a more equal distribution of income and wealth. The latter implies active redistribution policies by means of tax and social policies. The former requires that governments run permanent deficits (surpluses) in order to maintain aggregate demand at a level consistent with full employment, stable inflation, and a roughly balanced current account in the long run, and that they actively fight short-run shocks by means of countercyclical fiscal policies.

(iii) Re-construction of international macroeconomic policy coordination – in particular on the European level – and a new world financial order. On the European level, the institutional setting of the ECB and its monetary policy strategy have to be modified such that the ECB is induced to pursue a long-run monetary policy of low real interest rates. The Stability and Growth Pact has to be replaced by a means of coordination of national fiscal policies which allows for the short- and long-run stabilising role of fiscal policies. External stability, i.e. sustainable external balances, should be a primary target, and member countries should be symmetrically induced to correct for current account surpluses and deficits. The orientation of labour market and social policies towards deregulation and flexibilisation will have to be abandoned in favour of re-organising labour markets, stabilising labour unions and employer associations, and Euro area-wide minimum wage legislation. On the global level, the return towards a world financial order with fixed but adjustable exchange rates, symmetric adjustment obligations for current account deficit and surplus countries, and regulated international capital markets, as suggested by Keynes's (1942) proposal for an International Clearing Union, should be attempted in order to cope with the imbalances that have caused the present crisis.

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see http://www.hwr-berlin.de/index.php?id=4015?&L=1 for more information and publications

Further Reading

Eckhard Hein and Achim Truger (2010): Finance-dominated capitalism in crisis – the case for a global Keynesian New Deal, Berlin School of Economics and Law, Institute for International Political Economy, Working Paper 6/2010: (http://www.ipe-berlin.org/fileadmin/downloads/working_paper/ipe_working_paper_06.pdf)