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Crisis: Causes,  
prospects  
and alternatives

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# Preface

**Dan Cunniah**

Director,  
Bureau for Workers' Activities  
International Labour Office

The crisis of 2008 revealed the fault lines in the world economy for all to see. Three decades of a social experiment with radical market-oriented policies have not only failed to deliver decent standards of living to most workers around the world, but have brought us to the brink of a major world depression.

While the worst was avoided thanks to unorthodox fiscal and monetary policies, workers across the world are still paying the price of the policy failures through increased unemployment and precarious work, pay and benefits reductions, and cutbacks in public services, to name a few. And to add insult to injury, the very economic policies that failed us then are now making a comeback.

Though we are slowly coming out of the “great recession”, there is no question that the underlying structural problems that got us there are still with us: a fragile and still largely under-regulated financial system, depressed wages and widening income inequalities, and imbalances between debtor and surplus countries in matters of trade.

As it is, the economic recovery scenario that is playing out in front of our eyes is that of “competitive austerity”, where governments will restrain their spending and workers their earnings to restore “competitiveness”. But, as the ILO’s *World of Work Report 2010* observed, a premature fiscal consolidation runs a high risk of jeopardizing the recovery. And more importantly, collective salvation through exports (and wage restraint) will clearly not work if everyone applies these mechanisms.

If the crisis has taught us anything, it is that a new framework for economic policy is needed. While there is surely no one-size-fits-all set of policies, we need a new economic pragmatism that makes employment the foundation of policy-making. Already in 1964, the social partners at the ILO had understood this when the International Labour Conference adopted the Employment Policy Convention, 1964 (No. 122), which called for the use of all economic levers to promote full employment.

At the 99th International Labour Conference in June 2010, the ILO committed itself to intensifying its efforts to define new paths for macroeconomic policy. We can but applaud this renewed determination and promise that the Bureau for Workers' Activities will do its utmost to contribute to the discussion and to multiply the opportunities for exchange.

The contributions to this issue of the *International Journal of Labour Research* are a small step in this direction. They are drawn for the most part from a Global Labour University Conference on "Labour and the Global Crisis: Sharing the Burden (!) Shaping the Future (?)", held in Berlin in September 2010. The conference brought together young trade union activists from around the world as well as a new generation of academic researchers. Together they endeavoured to distil the lessons of the crisis for the labour movement and to define alternative ways forward.

I am sure readers of the *Journal* will agree with me in saying that this is more than an auspicious beginning. Trade union leaders should find this issue of tremendous help in their daily work of seeking to secure decent work for all workers and their families.

# Editorial

**Pierre Laliberté**

Editor

This issue of the *International Journal of Labour Research* addresses one of labour's central challenges for our times: that of defining and fighting for a worker- and environment-friendly economic perspective for the future.<sup>1</sup>

In the aftermath of the greatest systemic crisis since the 1930s, it has become clear that the economic orthodoxy that brought us to the brink has by and large failed to draw any lessons from the crisis: on the contrary, it has reasserted itself. Worse, after governments and central banks used every lever at their disposal to shore up the financial system and prevent another depression, the cost of Wall Street's excesses is now for the rest of us to pay. Without strong resistance and credible policy alternatives, it becomes evident that workers – in general and the public sector more specifically – are in for “shock therapy” treatment.

This was crystal clear from the pronouncements of political leaders at the G8/G20 meetings in 2010, where the concern over high unemployment totally vanished to make way for fiscal consolidation. Even beacons of economic orthodoxy such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) were somewhat more guarded than government leaders in pointing out that overly rapid fiscal “consolidation” in OECD countries might actually endanger the economic recovery itself. But the moderate tone of these institutions is itself in strong contrast to what they have recently prescribed to countries such as Greece, Hungary, Romania or Spain...

That the current policy direction will prove to be self-defeating is also apparent in the renewed obsession with “competitiveness” on both sides of the Atlantic. The notion that the whole world can export itself out of trouble ought to be a non-starter, but has apparently won favour with heads of State.

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1. This issue is largely based on contributions presented to the Global Labour University Conference held in Berlin in September 2010.

Of course, what this will mean for workers is a massive round of “competitive austerity” whereby the costs of the adjustments necessary for countries to emerge from the economic crisis will be administered through wage deflation and increased job insecurity, and will be “fiscalized” through cuts in social benefits and loss of public services. Not only will such a cure be painful for most, but it might indeed bleed the patient to death.

Other courses of action are feasible but as Michael Sommer, President of the International Trade Union Confederation (ITUC), points out in this issue, it is clear that:

There will be no changes in economic policy out of a sense of gratitude for our support at the height of the crisis. Only the persuasiveness of our arguments and public mobilization will bring about the necessary changes.

Trade unionists and progressive forces will need to demonstrate the determination and confidence required to confront not only the forces of vested interests and of the status quo, but also the equally paralysing “policy fatalism” that all too often influences public debate.

An employment-centred approach to economic policy is not only a welcome idea, but is indeed the only sensible way to get us back on the path of sustainable development. Globalization as we know it is not an immutable reality: it is shaped by social forces, a fact that ought not to be forgotten in the search for alternatives.

In the “post mortem” of the crisis, the recent two-year herd instinct of bankers and investors has been the subject of widespread criticism. It has become clear that most bankers prefer to follow the trend than to take an independent stand. Losing lots of money when everybody else is also losing poses no problem (especially when someone else absorbs the risk to the system...). What is true for bankers seems also to apply to researchers. It is much easier to repeat mainstream views with slight modifications than to provide a well-researched and evidence-based alternative view.

It can be said with confidence that contributors to this issue of the *International Journal of Labour Research* are the exceptions to the “security in numbers” trend in economics. The collective wisdom published in this issue provides an important contribution to the intellectual endeavour of understanding what led to the crisis and to establishing new building blocks for an alternative macroeconomic and development paradigm.

Robert Wade was invited to offer “predictions” on the likely economic developments in the next ten years given the current policy orientation. He depicts the present situation in these terms:

The central problem now is the imbalance between the mountain of financial claims on income and the flow of income. The financial sector is politically powerful enough to block measures that might write down its claims



on income, while it and other political forces are powerful enough to block the deficit spending which might stimulate output, employment, income and demand in the productive economy. The imbalance between excessive financial claims and excess capacity in the productive economy looks to be locked in for the medium term.

He then makes two broad predictions for the next decade: first, that as a result of the victory of the fiscal conservatives in most OECD countries and of insufficient re-regulation of the financial system, those countries are condemned, at best, to stagnation; second, that at least one major financial crisis is in the offing, owing to continued financial fragility as well as to the highly polarized income distribution worldwide.

In a parallel narrative, Eckhard Hein traces the deep roots of the last crisis to the financialization of the economy over the past three decades and its various consequences: insufficient regulation of financial markets, increasing inequality in the distribution of income, and imbalances in current accounts at the global level. He shows how income inequalities have risen in almost all OECD countries over this period: first through a decline in labour's share of national income; and second, in widening inequalities in personal income distribution.

To “resolve” the systemic problems caused by widespread declining wage income, two complementary policy responses have emerged: on the one hand, “debt-led” consumption in some key countries such as the United Kingdom and the United States; on the other, the somewhat more old-fashioned “export-led” mercantilist model exemplified notably by China, Germany and Japan.

This arrangement worked for a time as trade surplus countries kept re-investing their earnings back to subsidize the debt of deficit countries. The apparent “stability” of the relationship even led some to believe that it could go on indefinitely. But of course, there are limits to the amounts of debt that can be sustained on stagnant income, so when interest rates began to rise in the United States in 2006 and the weakest link in the chain – the market for subprime securities – broke down, the perverse but predictable chain-reaction effects that were provoked spread like wildfire throughout financial markets.

As the traditional “consumption” engines of the global economy are now experiencing deleveraging, fiscal restraint and slow growth, reverting to the pre-crisis arrangement is no longer an option. When it comes to Europe and the United States, the main question given the current policy path is whether they will be able to avert a Japanese-style deflation.

Many have put their faith in a recovery led by emerging market economies such as Brazil, China and others: this is known as the so-called decoupling thesis. While these economies are currently experiencing signs of overheating, due in part to the maintenance of easy (low-interest) monetary policies in Europe, Japan and the United States, it is questionable whether the emerging

economies are large enough, or whether they can switch from export-driven to domestically driven demand to make up for the lack of growth in other key countries.

To get the world economy back onto a sustainable path, Hein proposes what he calls the “Keynesian New Deal” at the global and European level. A key component of this strategy is a wage-led recovery plan which, in his own words:

requires addressing the three main causes for the fall in the labour income share in the period of neo-liberalism and financialization: first, the bargaining power of trade unions has to be stabilized and enhanced; second, overhead costs of firms must be reduced, in particular top management earnings and interest payments, as well as profit claims of financial wealth holders; and third, the sectoral composition of the economy has to be shifted away from the high-profit-share financial corporations towards the non-financial corporate sector and the public sector.

In addition, Hein and Truger<sup>2</sup> identify three other mutually reinforcing pillars to a Keynesian New Deal, namely the re-regulation of the financial sector; the reorientation of macroeconomic policies “with an eye to domestic demand, in particular in current account surplus countries”; and, finally, the reconstruction of international macroeconomic policy coordination.

The need for a new macroeconomic paradigm is no doubt the most important element discussed in this issue. In fact, even before the 2008 crisis, there were already calls – based in large part on the performance of countries under the spell of “structural policy programmes” – to re-examine the core tenets of the orthodox paradigm.

In his article, Iyanatul Islam does just that. He reviews the relevance of “core” mainstream macroeconomic policy proposals such as the maintenance of single-digit low inflation targets, and arbitrary and limitative fiscal rules for deficit and debt levels. Instead, he proposes that full employment and development considerations be given priority in the norms and conventions that inform macroeconomic policy. As he puts it:

The reinstatement of one of the ten commitments of the Copenhagen Declaration represents a most welcome change after decades in which orthodox macroeconomics held sway and the notion of full employment became marginalized in the operational guidelines of central banks and finance ministries across the world. Indeed, MDG target 1B, along with ILO

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2. E. Hein and A. Truger: “Finance-dominated capitalism in crisis – the case for a Keynesian New Deal at the European and the global level”, in P. Arestis and M. Sawyer (eds): *New economics as mainstream economics*, International Papers in Political Economy (Basingstoke, Palgrave Macmillan, forthcoming).

Convention No. 122, which “aims to stimulate economic growth based on full, productive and freely chosen employment”, can serve as a beacon to guide the current quest for an appropriate post-crisis macroeconomic policy paradigm.

Using historical evidence, Islam makes an important and convincing case that there is much more room for manoeuvre in pursuing alternative, employment-centred economic policies than is usually believed by mainstream economists. He does not advocate a one-size-fits-all programme for such an endeavour, but rather a pragmatic approach that matches a country’s unique situation. As he remarks, a strong political commitment to full employment in itself:

reduce[s] incentives for central banks and finance ministries to be pre-occupied with attaining low, single-digit inflation and predetermined fiscal targets. This could alleviate either self-imposed or externally enabled constraints on policy space and encourage the key macroeconomic policy managers at the country level to act as agents of development. In the case of central banks, this would mean identifying ways in which equitable access to finance could be enhanced for small and medium-sized enterprises (SMEs) that represent a major source of job creation. In the case of finance ministries, this would mean finding non-inflationary sources of finance – such as raising tax-to-GDP ratio in cases where the tax burden is low – to support much-needed public investment in infrastructure.

Islam goes on to offer further recommendations that could form the basis of a heterodox approach to macroeconomic and development policy. Among other things, he emphasizes the need for proactive countercyclical fiscal policies, as well as a monetary policy that focuses on real exchange-rate stability.

In the same vein, Hein proposes in his article a post-Keynesian macroeconomic mix where interest rate policies would abstain from “fine-tuning” unemployment in the short run to ensure low inflation, but would instead target real interest rates below the rate of productivity growth so as to stimulate aggregate demand. Fiscal policy for its part would “be responsible for real stabilization, full employment and a more equal distribution of disposable income”.

With monetary policy concerning itself more with full employment and external balances, incomes and wage policies would need to take over responsibility for maintaining price inflation within reasonable bounds.

In order to achieve the nominal wage growth targets, a high degree of wage bargaining coordination at the macroeconomic level, and organized labour markets with strong labour unions and employer associations, seem to be a necessary condition. Legal minimum wage legislation should contain wage dispersion and thus contribute to a more equal distribution of income.

This is an important consideration for trade unions and a powerful argument in favour of renewed efforts towards centralized and coordinated bargaining.

Without doubt, a key component of a global Keynesian New Deal is the establishment of policy coordination at the international level to prevent “beggar-thy-neighbour” types of policy. Robert Wade exposes the current conundrum:

The most serious gap in the international financial system is a mechanism for curbing payments imbalances without putting all the adjustment pressure on the deficit countries. The market for foreign exchange is barely fulfilling this function. It is driven more by speculative capital flows than by trade flows, and it moves exchange rates in crazy directions, like drunken air traffic controllers. Countries running large deficits and high inflation may experience currency *appreciation*, as “carry trade” investors seek to profit from both the high interest rates and the prospect of further currency appreciation – the story in much of Eastern Europe and also, especially, in Iceland. Meanwhile, some governments peg their exchange rate to that of their main export market, even as they accumulate large external surpluses and large reserves, partly so as to substitute for World Trade Organization (WTO)-prohibited tariffs, quantitative restrictions and other industrial policies.

In the face of the current international disorder with respect to exchange rates and financial flows, renewed efforts need to be undertaken to create an environment in which surplus and deficit countries would both face equal adjustment pressures and where capital flows would be regulated.

This could be largely achieved through an International Clearing Union where a new international “accounting” currency would take the place of the US dollar as the main reserve currency. While the political obstacles to such a proposal are enormous, one cannot fail to observe that not since the 1940s have conditions been better for a thorough discussion of such a move. In his article, Trevor Evans recounts Europe’s experience of the crisis and how its fledgling institutions were ill-equipped to handle the sovereign debt crisis that followed from the bailout of the financial sector and from the crisis itself. In his view, “[the] problems in the peripheral European countries are not simply the result of developments within these countries but also reflect major imbalances in the euro area”. As he puts it:

The widening divergences between the members of the euro area demonstrate the need for a more coordinated approach to economic policy. The Growth and Stability Pact, which requires euro area governments to maintain a fiscal deficit below 3 per cent of GDP, is quite unable to deal with the imbalances between countries. Attempting to deal with such imbalances by

forcing countries with a deficit to implement deflationary policies will, ultimately, also harm the surplus countries, such as Germany, which depend on the euro area market. Indeed, Germany is one of the countries that have most benefited from the euro since its principal trade partners are now locked into irrevocable exchange rates.

Evans goes on to suggest that euro area countries develop a coordinated economic policy aimed at promoting full employment and featuring, among other things, public-led investments related notably to the demands of climate change. He proposes that in the long run the European Union develop the capacity to conduct its own fiscal policy, by a partial centralization of its levers and budget. He endorses the idea of emitting euro bonds as a way of taking some pressure off countries with high debt burdens.

For their part, Carlos Salas and Anselmo dos Santos offer a comparative analysis of the economic and labour market performance of Brazil and Mexico, Latin America's largest economies, both before and during the crisis. Attributing Brazil's better outcomes to the adoption of a combination of pro-development policies, they highlight the fact that by shoring up the income of the poorest, redistributive policies have paid off handsomely for Brazil, as have industrial policies in steering the economy towards higher-value-added sectors.

If the two countries started out from a somewhat similar conservative macroeconomic policy mindset in the early 2000s, they point out that this changed in the case of Brazil:

[T]hat is only a part of the whole story. Other significant similarities include a concern for domestic market growth, using the stimulus of state banks; a pro-growth strategy (named the PAC Programme) to accelerate growth, which also seeks to diminish regional development gaps; and a major housing programme (*Minha casa, minha vida* – My home, my life) which has injected resources for the construction of hundreds of thousands of new dwellings and had an important impact on many industries, in addition to the construction activities. Use of state resources to stimulate the economy is a common feature of all these policies.

Last but not least, if there is one crucial area where policy-makers have largely failed in response to the crisis, it is surely that of re-regulating the financial system. In view of the enormous economic and social costs of the financial crisis, the ongoing fiscal burden it has generated and the glaring inefficiencies of the current system, there was a widely shared expectation that re-regulation ought to have been the first order of the day for the G8/G20. There was indeed much activity. The United States and the Bank for International Settlement (BIS), notably, did make gestures to address some aspects of the problems. However, it is fair to say that the proposals were too few and not

sufficiently far-reaching and that the most important problems remained unresolved, notably concerning the size of financial institutions and the ensuing risk implications for the economy.

On this issue, Hansjörg Herr provides a thorough and much-needed overview of the arcane world of financial reform. He identifies some of the salient problems and puts forward proposals to help ensure that financial institutions perform their role, namely to deliver “sufficient credit for productive activities at low interest rates”. As he concludes:

A financial system as outlined above is not utopian. For instance, it existed more or less in the United States as well as in other industrial countries after the Second World War. Comprehensively regulated systems with interest rate control, international capital controls and almost no non-bank financial institutions existed, and to some extent still exist in various versions in all the economically successful East Asian countries.

In the end, it has to be said that while most of the alternative proposals made in this issue can be advocated at the national level, they would have a much greater chance of success if they were part of an international commitment to the goal of securing decent work for all; if there were mutually reinforcing measures in matters of taxation, exchange-rate management, capital and trade flow regulations and labour standards, in order to ensure that countries which choose to prioritize development and employment can do so in an environment that will be supportive rather than penalizing.

This basic truth should alert trade unions to the need to urgently develop the capacity to coordinate actions and campaigns internationally. This would surely be the best antidote to the ongoing calls for greater “competitiveness” and self-defeating fiscal austerity at the national level. Indeed, the time is ripe for trade unions to become truly international actors.

# A labour agenda for change

*A presentation at the Global Labour  
Conference, Berlin, September 2010*

**Michael Sommer**

President,  
International Trade Union Confederation

Dear colleagues,

Many thanks for inviting me to this Global Labour University Conference here in Berlin, in Schöneberg Town Hall. It is here that John F. Kennedy made his now famous declaration "*Ich bin ein Berliner*" (I am a Berliner), thereby demonstrating American solidarity with the walled-in people of the city. It is also here that Willy Brandt, then Mayor of Berlin and passionate champion of freedom and justice, became the leader of the German social democratic movement. It was his firm belief that freedom, social justice and democracy are interdependent and make each other possible. That insight is as valid today as it was then.

Today, freedom and justice must be considered globally. The Global Labour University is making a vital contribution to this, which is why we in the German unions and the global unions are among the committed supporters of the Global Labour University.

In addressing the theme of the Conference, "Sharing the burden (!) – Shaping the future?", I will focus on the labour agenda for change: what do we think needs changing and what can we do to change it?

The past three years of crisis have left trade unions and many others without a doubt that social justice and basic common sense can be attained only by a fundamental shift in our national and international economic policy.

But in the wake of the unprecedented bailout of banks and financial investors, the need for systemic change is once again being ignored. When the crisis situation was acute the support of unions was sought, but now the effects of that crisis on the labour market are being used to demand further pay cuts and the removal of provisions designed to protect workers.

We in the unions have no illusions. There will be no changes in economic policy out of a sense of gratitude for our support at the height of the crisis. Only the persuasiveness of our arguments and public mobilization will bring about the necessary changes.

The crisis has not yet been overcome. By saving the banks and introducing economic packages, politicians have merely tackled the symptoms. In that, they have been more or less successful, depending on which country you look at. But the systemic causes of the crisis have remained untouched. The restrictions placed on those who caused the crisis – the financial market actors, are much smaller than is the impact on those who have been most affected by it – the workers:

- Worldwide, almost 212 million people are unemployed. That is 30 million more than in 2007.
- During 2009, precarious employment grew substantially, meaning that 50.6 per cent of the world's workforce is now in unprotected jobs.
- The number of jobless youth worldwide rose by 10.2 million in 2009 – the largest increase since 1991.



Both the causes and effects of this crisis have reached global proportions. Consequently, solutions adopted by nation States alone are less effective than are coordinated international measures. The precondition for meaningful action is agreement on joint priorities. Of course, the starting points and possibilities for action will vary from country to country, depending on the economic and political circumstances of each. Nonetheless, if trade unions are to be heard internationally, and if we want to combine our strengths, it is vital that we should concentrate on a few joint priorities. We cannot afford the luxury of everyone riding their own hobbyhorses.

At present I see four central tasks:

- (1) achieving full employment and productivity-related wage development;
- (2) ensuring future prospects, training and employment opportunities for young people;
- (3) overcoming precarious and informal types of employment, notably through guaranteed minimum wages and universal social security; and
- (4) protecting workers' rights.

Full employment must be the ultimate goal of any national and international economic policy. But not any kind of employment. We must aim for good-quality employment that pays a wage guaranteeing a decent standard of living and a share in society's productivity and growth. We aim for employment that reduces health risks to the minimum and respects occupational safety standards.

As well, we must create employment that meets the great challenges of the future. We need to reach an ecological turning point in our industrial policy, to put public infrastructure in place as well as to provide public health care, public housing construction and public education to ensure security and equal opportunities for all. This will not be possible without greater taxation of high incomes and wealth. We must therefore take decisive steps to abolish tax havens, introduce a tax on financial transactions and raise the taxes on wealth and inheritance.

But equally, acceptance of an appropriate tax ratio for middle incomes is vital if we are to meet social and ecological challenges. In the industrialized countries, a State cannot be properly run on a tax ratio of less than 45 per cent of GDP. Nor will developing countries be able to make decisive investments in development without an increase in their revenues. Since 40 per cent of the world's wealth is owned by 1 per cent of its population, it seems both appropriate and necessary to finance anti-crisis measures through higher taxation of fortunes, profits and top earnings.

Manipulative exchange-rate policies, systematic foreign trade surpluses and a race to the bottom on taxes are beggar-thy-neighbour policies that must be overcome through resolute cooperation. To maintain an open world economy, economic globalization must be accompanied by globalized regulatory practices. In this context, the implementation of international minimum labour standards is more urgent than ever.

Unless and until the worldwide employment crisis is reined in and brought under control, the heads of State and government of the G20 countries have no right to act as though the worst is behind us. This is why the choice of “The G20’s role in the post-crisis world” as the theme for the next G20 summit is, in my view, both premature and offensive.

The international trade union movement held high hopes of the G20 process. The words committed to paper in London and Pittsburgh by the heads of State did, in part, read like the master plan for a new and more just world economy. Unfortunately, the fine words led to few fine deeds:

- Through a financial transaction tax, those responsible for the crisis were supposed to make a significant contribution to the costs of consolidation. I see no sign of serious ongoing work on this issue.
- The “Charter for Sustainable Economic Activity”, which was to provide a new policy framework for global economic governance, has utterly vanished from the G20 negotiating table.

Instead, at their June 2010 meeting in Canada, the G20 agreed that fiscal consolidation was the new priority. And sure enough, the old misguided call for labour market flexibilization was made once again, as if labour market deregulation and the resulting downward pressure on wages were not part of the problem.

The G20 will not arrive at viable solutions unless they become more than the mere trustees of global economic interests. They must set the course for a more stable world economy, work for a just sharing of burdens and, therefore, also bring the trade unions and other representative non-governmental organizations into this process.

In Germany, and no doubt elsewhere, the simple fact is that without the involvement of trade unions and particularly their workplace representatives the crisis would have had far more serious consequences.

The negotiation of short-time working arrangements as well as proposals by the unions to revive the economy and demand (such as the car scrappage premium) led in at least some sectors of our national economy to a noticeable improvement of the employment situation.

During the crisis, much of what the politicians did, together with the trade unions and the employers, was done right. Manifestly, Germany’s social market economy handled the consequences of the crisis better than other governance models, but now that we are seeing the first signs of economic recovery, Germany too is repeating many of its previous mistakes.

Precarious employment conditions, which directly led to unemployment during the crisis, are rising very quickly. Employers are making more use of agency labour and fixed-term employment. That is why we support the minimum wage, equal pay for agency work and an end to state-subsidized poverty wages.

One more point on the subject of pay. Job creation is crucially dependent on developments in overall demand, but demand itself is crucially dependent on wage developments. Wages and social benefits are more than business costs, they are the fertile ground from which economic growth and higher employment can spring. It is therefore crucial that pay be increased in countries where the economic figures are positive. This applies notably to the Federal Republic of Germany.

The size of the pay increase must at least match the rise in productivity and the rate of inflation. Worldwide economic recovery can be achieved only through stronger bargaining policies and higher incomes. This will require a combination of wage bargaining policies, legal minimum wages, affordable public services, social security for all and a policy of fair distribution of taxation.

The pre-crisis trend towards globalization contributed significantly to the decoupling of wage developments from productivity developments. In almost every country, labour rights were weakened in the name of international competitiveness. The expansion of precarious and informal employment, together with high unemployment rates, were instrumental in increasing the pressure on wage levels overall.

More than 90 years ago, the ILO was founded because States, as well as employers and trade unions, saw the dangers of a regulatory race to the bottom. International labour standards were to guarantee the minimum labour and social policy norms for an open world economy. The prevention of wage dumping was seen as an indispensable precondition for convincing countries to open up their markets and to refrain from taking protectionist measures.

Ninety years later, we must note that while the basic premise behind the creation of the ILO still carries conviction, practice does not. The international labour standards do offer a meaningful regulatory framework for converting precarious and informal employment into decent work conditions, but governments lack the determination required to ratify and apply those standards. The ILO process itself seems to me to be too slow, given the dynamics of globalization. Both these factors have to change. If not, I see no reason why we as trade unionists should continue to devote so much time and energy in support of the ILO. We need a stronger, internationally agreed commitment by governments that they will not merely vote for labour standards in Geneva, but that they will indeed transpose them into national law and practice back home. We need an International Labour Office that focuses on its core business: defining and ensuring respect for international labour standards.

Finally, I would like to issue a warning. For the past three decades, we have had to put up with neoliberal economic prescriptions that have led to increased government debt, higher unemployment and poverty, as well as a substantial weakening of the financial basis of the social welfare state. But

in the aftermath of the greatest recession in a lifetime, our “elites” are back at it, once again proposing cures that are part of the disease: cuts in social spending, privatization of public services, hands-off treatment for large financial fortunes, and labour market flexibilization through the reduction of workers’ rights. But beware! The age of neoliberalism and financial market capitalism is over.

We in the trade unions will not allow the politicians to shirk their responsibilities. It is their job to radically improve the course of the world economy. It is their job to bring about sustainable, employment-creating growth. And it is their job to prove to us that our countries are ruled not solely by financial interests, but by governments which have all the people’s interests at heart.

If we have not learned that lesson from the current crisis, what else has to happen before we do?

# The Great Slump

*What next?*

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Over the 2000s a towering mountain of financial claims on income from the productive economy accumulated in many western economies. The financial sector manoeuvred itself into a position where it made returns of 12 per cent per year or more in economies growing at 3 per cent a year or less, and accrued a large and fast-growing share of total corporate profits. Meanwhile, output growth in the productive economy depended on consumers buying on credit, because incomes of the bulk of the population grew hardly at all. Most of the growth in national disposable income accrued to those at the very top of the income distribution – who invested in the financial economy, blowing up financial claims on income (through the stock market, mortgage refinancing market, pension market, hedge funds, private equity funds, credit derivatives and the like). The giant US current account deficits added to the resulting “financialization of the economy” as the associated capital inflows provided the basis for more rounds of profitable financial transactions.

The central problem now is the imbalance between the mountain of financial claims on income and the flow of income. The financial sector is politically powerful enough to block measures that might write down its claims on income, while it and other political forces are powerful enough to block the deficit spending which might stimulate output, employment, income and demand in the productive economy. The imbalance between excessive financial claims and excess capacity in the productive economy looks to be locked in for the medium term (Wade, 2009b, 2009c; Skarstein, 2011).

If there is good news, it is that the utopians of free-market capitalism, whose thinking dominated most western governments for the best part of three decades and who somehow forgot that prosperity based on credit is dangerous (“this time is different”) have received a stinging rebuke. The rebuke widens the scope for reconsidering appropriate policies and institutions of modern capitalism, including in the middle-income countries.

What is likely to happen over the next decade? Here I present two broad predictions, based on the above argument. My interest is less in the predictions themselves than in the reasons behind them.

**Prediction 1.** *Three of the four largest zones of the world economy – the United States, much of Europe, and Japan – will see slow and erratic economic growth in the next several years, with continuing economic insecurity for most of the population. The fourth zone – big “emerging market” economies – will experience faster growth and asset price inflation, with the possibility of macroeconomic shocks akin to the East Asian crisis of 1997.*

As of late 2010 media headlines proclaimed good news: “Markets soar on signs of action to calm Europe” (Jolly, 2010); “Output grows at fastest rate in 16 years” (Pimlott, 2010, referring to UK manufacturing). Global GDP

growth is likely to register 5 per cent in 2010, well above the historic trend. Germany's growth for 2010 is likely to be around 4 per cent, China's around 10 per cent. India and Brazil are also growing relatively fast. The problems of the European periphery are a side-show on a global scale. The summer 2010 slowdown in economic activity in the West, which some analysts interpreted as the beginning of a second recession, now looks to have been just a lull in steady recovery from the 2008–09 downturn.

But there is a small problem with this good news story. It rests on the assumption that the growth mechanism of the 2003–07 boom can be re-established in a way which will be stable this time; in other words, on the assumption that the medicine which made the economy sick can now cure it when the dosage is repeated. Just as the 2003–07 boom was driven by US households and government running up debt and the economy running up external deficits, so the pick-up in global growth over 2010 is again being fuelled by spending on credit. The US trade deficit soared in late 2010 (US\$44 billion in September 2010, not far from twice as high as in May 2009, at the peak of the recession). This deficit directly and indirectly fuels China's growth; and Brazil's, Germany's and Japan's growth depend in turn on exports to China. Furthermore, the cuts in US taxes and public spending, combined with loose monetary policy, will probably produce even more income concentration at the top through their effects on stock prices. The flow of liquid capital out of the United States and other countries engaged in "quantitative easing" and into the larger developing countries is putting upward pressure on currencies and asset prices there. In short, the global growth mechanism is producing higher economic growth, but – with its continual reliance on a large US trade deficit – is vulnerable to another rupture.

Let us step back from the present and take a longer view, beginning with the metaphor of the economy as a car (Palley, 2009). When households borrow they are stepping on the accelerator – but at the same time loading up the car with more weight (debt). When they stop borrowing they take their foot off the accelerator and the car slows faster than otherwise because of the extra weight. This is the first dip. Then when households increase savings and repay debt they are stepping on the brake, so the car slows even faster than by just lifting the foot from the accelerator. This is the second dip. Replicated across the economy, braking the car – deleveraging or repaying debt – causes a multiplier process of lower spending, job losses, business failures and bank failures.

US gross domestic product (GDP) rose by 16 per cent between 2000 and 2006, while private consumption rose by 20 per cent. Real wages were stagnant; indeed, over the whole period from 1973 to 2006 average real wages (outside agriculture) rose by less than 1 per cent, while labour productivity rose by more than 80 per cent. So households increased their consumption by loading up on debt, raising the ratio of household debt to disposable income by 97 per cent between 2000 and 2006, to the point where the ratio of debt

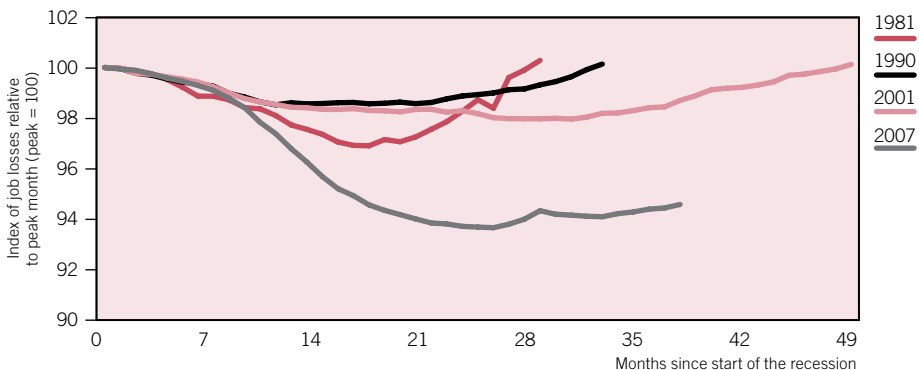
to disposable income reached 133 per cent in 2007. This is the household debt mountain now weighing down on the economy.

The severity of the resulting slump is caught in figure 1, which shows the percentage fall in employment in the United States in all the post-Second World War recessions, each trend line starting at the peak. The current recession has produced a much deeper and longer fall in jobs than previous ones – and two-and-a-half years on from the peak has shown little sign of a significant upturn. US unemployment remains around 10 per cent (almost double when part-timers wanting full-time work are included), and the average period of unemployment is now eight months, by far the longest such period since 1950 (the previous peak was 4.5 months around 1984). Treasury Secretary Geithner declared, “we’re on the road to recovery”; but if recovery is defined as a rising number of people in secure employment there is no US recovery as yet. In most of Europe, too, a modest recovery in economic growth has been accompanied by little recovery of (permanent) jobs.

This is surprising, because the profits of banks and large non-financial corporations have bounced back to close to where they were before the crisis. The investment banks Goldman Sachs and Morgan Stanley have done particularly well, their share price up to within 10 per cent of their peak before the Lehman collapse. But restored company profits have not been translated into jobs, for at least two reasons. One is that much of the profit comes from offshore operations (for example, General Motors (GM) now makes most of its cars in China, where it employs 32,000 hourly workers, as against only 52,000 hourly workers in the United States, down from 468,000 in 1970). The second is that large US and European businesses have been investing heavily in labour-saving equipment, which boosts their profits but not their employment.

The US housing market continues to act as a brake. Average house prices have already fallen from the peak by about 35 per cent. But the US

**Figure 1. Length and depth of recent recessions in the United States, 1981–2011**



Source: Bureau of Labor Statistics and author's calculations.



housing bubble over the 2000s grew much bigger than the housing bubbles in the five worst financial crises in the developed countries between the late 1970s and 2008, and in these other cases it took four to five years for house prices to fall to pre-bubble price levels relative to incomes. If the US housing market takes this long to deflate, prices would fall till late 2011 or 2012, continuing to destabilize the financial system; and since the US housing bubble was larger the fall might last longer (Reinhart and Rogoff, 2008).

As of September 2010 the volume of US housing transactions relative to population was the lowest since late 1982. Half of all households had less than 20 per cent equity remaining in their homes, meaning they must have savings available to qualify for a government-insured loan. A large stock of foreclosed housing was on the market and another large stock of likely-to-be-foreclosed housing was ready to come on the market, further depressing prices.<sup>1</sup> The cost of mortgages was at a record low, but low interest rates have lost their power to stimulate demand. The housing market interacts with the labour market: many unemployed people in areas with unemployment rates of 12 per cent and more cannot move because they owe more on their house than its market value.

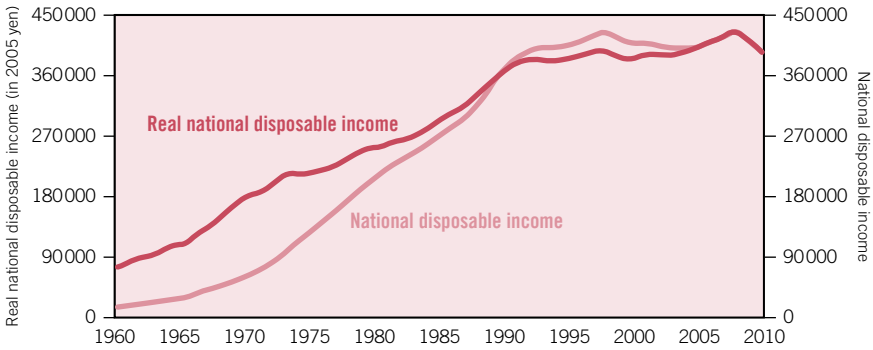
In short, the United States and much of Europe are mired in a liquidity trap, where central banks' loose monetary policy has no more effect than pushing on a piece of string. Big financial and non-financial companies are flush with cash but unwilling to invest at home because of uncertainties about demand. They won't hire more people until confident that consumers will buy their products; and consumers won't buy until they have secure incomes and have paid down some of their debt (Reich, 2010). It is difficult to see how the situation might turn the corner, because there are no corners in a vicious circle.

The prospect of a Japanese-style stagnation beckons. Japan's fast economic growth through the 1960s to the 1980s morphed into bubble growth in the second half of the 1980s, and the bubble burst at the end of the 1980s. The ensuing "trouble" lasted two decades (figure 2). Deflation was one main reason; for example, average salaries in Japan fell by 12 per cent over the 2000s. From an American perspective the question is whether the sharp downturn in US national income growth which began in 2007 (figure 3) will take a similar trajectory to Japan's after 1990, in which case normal growth would not resume till some time after 2027.

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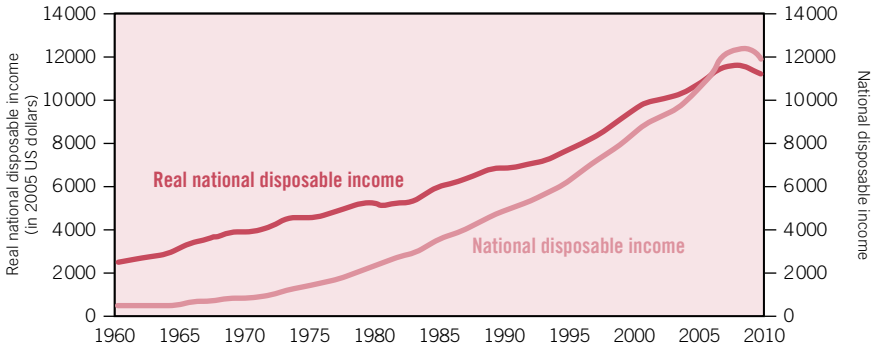
1. Lex Column, "Disinterest rates", *Financial Times*, 16 Sep. 2010, p. 18. Foreclosure has far-reaching effects. When even a few houses are foreclosed other households in the area may try to sell to escape the reputation effect, putting downward pressure on all house prices and putting more mortgage holders under water.

**Figure 2. Japan: National disposable income 1960–2010, yen billions**



Source: IMF and author's calculations.

**Figure 3. United States: National disposable income 1960–2010, US\$ billions**



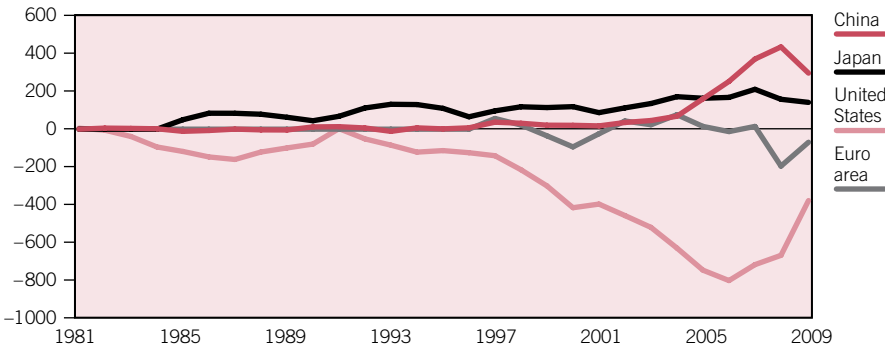
Source: IMF and author's calculations.

## Payments imbalances

Figure 4 shows another of the bulldozer forces making for instability – the growth of huge payments imbalances over the 2000s, with the United States running larger and larger deficits financed by capital flows mainly from East Asia, especially from Japan and from China in the second half of the past decade. These imbalances and associated capital flows were an important cause of the current crisis, for reasons explained below. They remain very large (Wade, 2009b, 2009c).

The specific problem is that Japan, Germany and (partially) China are determined to rely on exports for their growth rather than expand domestic demand – and therefore rely on *others* to expand their domestic demand, at the same time as many of those others, notably the United Kingdom and United States, are trying to reduce huge external deficits by boosting *their*

Figure 4. Current account balances, 1990–2009, US\$ billions



Source: Bureau of Labor Statistics and author's calculations.

exports.<sup>2</sup> This is a recipe for trade conflict. At the end of September 2010 the US House of Representatives passed legislation by a large and rare bipartisan majority, authorizing special tariffs on Chinese imports to counter Chinese “currency manipulation” (keeping the yuan undervalued).

### Cutters and stimulators

This brings us to the great debate for the past year and a half between “cutters” and “stimulators”, between fiscal conservatives who say that cutting fiscal deficits is the top priority and those who say that the top priority is to continue with fiscal stimulus until the recovery is assured, at which point economic growth will itself help to reduce the spending deficit.

The cutters appeal emotionally to the popular misperception that governments are like households writ large. A household with a cash-flow problem must tighten its belt, and so must government, they say, forgetting Keynes. Their slightly more analytical argument is that financial markets are afraid that government debt is spiralling out of control; that public deficit spending crowds out private spending (so that when the government issues a lot of debt, private investment and output fall); and that cutting the deficit will convince consumers and businesses that taxes will eventually be cut, encouraging them to spend more now. In short, they argue that fiscal austerity supports rather than harms growth. John Cochrane, a University of Chicago economist and Cato Institute member, put it succinctly when he declared, “The economy can recover very quickly from a credit crunch if left on its own” (Cochrane, 2010).

2. The Chinese Government is beginning to take sizeable steps to boost domestic consumption (Leonhardt, 2010). Its fiscal stimulus programme announced in late 2008 was twice as large relative to the size of the economy as that of the United States.

The growth stimulators do not accept these arguments. They say, first, that when consumers and businesses see the deficit being cut they are unlikely to calculate that since their taxes will eventually come down they can increase their spending today; rather, they will calculate that they may lose their job and will therefore tighten their belts, intensifying recession.

The stimulators say, second, that if the cutters are right about the crowding-out effect of government debt we would expect to see the yield on government debt high and rising, reflecting tightening competition for credit. In fact, real interest rates are close to zero, aside from extreme cases such as Greece, Iceland, Ireland and Portugal. “Markets” are more worried about a growth slowdown than about unsustainable debt, and afraid that a second dip would produce deflation, which would be even more difficult to escape from. As Martin Wolf, the *Financial Times* columnist, said about the United Kingdom recently, “the market is screaming its lack of concern about UK fiscal credibility”, as indicated by very low yields on UK government bonds. He accused the UK deficit cutters of being “terrified of a confidence bogey who is asleep” (Wolf, 2010a).<sup>3</sup>

The stimulators recommend that governments should withdraw stimulus and cut the fiscal deficit *in step with* the recovery of private business and consumer demand. For example, cutting might be calibrated to the rate of economic growth such that when growth remains at or below 2 per cent deficit spending or cutting certain taxes would be emphasized; as growth rises above 2 per cent, cutting public spending and raising certain taxes could be accelerated. The key point is that if the stimulus is withdrawn before the recovery of private domestic demand, recovery will depend on exports, which shifts the burden of providing demand stimulus on to others (the German strategy). The stimulators say that much of the growth that occurred in the industrialized countries in the second half of 2009 and first half of 2010 (excluding the export-led economies such as Germany and Japan) was due to inventory restocking after the collapse of 2008 and 2009, and inventory restocking is no basis for sustained growth.

In current conditions, say the stimulators, the magnitude and speed of public spending cuts advocated by the cutters (the British coalition Government has called for a departmental average 25 per cent cut in UK public spending over the five-year term of the parliament) will cause a new recession – and *higher* deficits. Furthermore, the cuts will undermine the long-term rate of growth, because of the destructive effect of bankruptcies and long periods of unemployment on skills, motivation and “social capital”.

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3. The UK Government argues that borrowing costs have been contained only because of its plans for tough spending cuts. Not so. The spreads on UK government debt over German bonds stabilized in February 2010 and have fallen only 0.2 percentage points since the election, which suggests that the Government’s strong fiscal stance has brought only modest credibility gains (see Wolf, 2010b).

So far, the “cutters” have won. Across Europe the biggest spending cuts since the 1930s are under way as of late 2010, and local newspaper pages are full of stories of fear and outrage as public services are cut and people lose employment in public sector jobs. The whole continent will probably be gripped by concerted fiscal austerity in 2011. The cutters have also prevailed in the European Central Bank, and in the “consensus” which the British and German governments got the G20 leaders to endorse at the Toronto summit in June 2010 (against some resistance from the Obama administration). The new Republican majority in the US Congress after the November 2010 elections will block any further stimulus. The leader of the Republicans in the House of Representatives, John Boehner, wants sharp spending cuts, especially welfare payments, together with large tax cuts for the wealthy – a recipe for bigger deficits and fewer jobs. Post-election, he and his party have moved from obstructing the Obama Administration to actually setting policy (Krugman, 2010).

The US Central Bank is riding to the rescue by starting another round of the modern version of printing money, quantitative “easing” (no-one could oppose something called “easing”). It hopes to boost investment, asset prices, and exports – and also boost inflation to erode the debt mountain. A more likely result is to stimulate the interest-sensitive sectors (the stock market and the housing market), slow down the needed re-specialization out of construction and finance and into export industries, and force appreciation of other countries’ currencies, including those of poor countries trying to build export industries. Currency wars may turn into trade wars.

In short, the cutters’ victory means there is a high probability that much of the West will experience a multi-year stagnation combined with high economic insecurity as the debt mountain is wound down. It is as though the cutters are repeating the voyage of the *Titanic*, ignoring warnings of “iceberg ahead”. Even more remarkably, they are doing so with the certainty that they are right, despite the lesson from the 1930s and from Japan’s experience after 1990 that once deflation takes hold it is difficult to escape from. They ignore the reasons why the labour market is quite different from the market for potatoes (cuts in wages tend to make the over-supply problem worse rather than better, unlike cuts in the price of potatoes), and the reasons why the government budget is not like a household budget writ large.

But there are glimmers of hope. The Organisation for Economic Co-operation and Development (OECD), the West’s leading governmental economic think tank, suddenly did a U-turn over cuts in September 2010. Having been urging OECD governments to give top priority to cutting fiscal deficits, it now urges them to postpone fiscal austerity at least until it becomes clear whether the sharp slowdown in economic growth over the summer of 2010 is temporary or long-term (Elliott and Kollwe, 2010). The OECD’s change of heart might slow down the rush to cut fiscal deficits and thereby lower the probability that the developed world will experience a double-dip recession.

The US election that delivered the majority in the House of Representatives to the Republicans in November 2010 might even turn out to have an upside. Now the Republicans and the Tea Partyists have to unite, which may be difficult, and then give the people what they want. The last time the Republicans were in the same situation they closed down the federal government, and lost the next election. This time they may fall apart under the responsibility of governing. President Obama may be able to use his veto to protect his existing achievements and gain support as the fearful electorate becomes disillusioned with the Republicans.

### Emerging markets

The real good news story of the past year and a half is China's and some other emerging markets' fast growth. Foreign capital is pouring in. But the other side of their success is overheating, inflation, and asset bubbles, which are only too likely to backfire into trouble. After all, most emerging markets have a long record of volatile growth, with little correlation in growth rates from one decade to another. The current mood of exuberance is ominously similar to the mood in the Republic of Korea and South-East Asia in the mid-1990s, before the great crash of 1997.

Loose monetary policy in the United States and the risk of sovereign debt defaults in Europe are helping to drive capital into the emerging markets and blow up asset bubbles. The host central banks are reluctant to raise interest rates for fear of attracting more capital; yet inflation is rising. China's growth remains dependent on rising demand from America and resulting US trade deficits; and other emerging markets' growth remains dependent on exports to China. A US\$1 fall in China's exports to the United States or Europe causes a bigger fall in imports from the rest of East Asia than a \$1 fall in China's domestic demand. A macroeconomic shock coming out of these instabilities would blow back onto US and European recovery and economic growth in the rest of East Asia and in parts of Latin America.

**Prediction 2a.** *The next decade will see at least one major financial crisis affecting a large part of the world economy, because the effort to re-regulate the financial system has largely failed.*

For the past two decades and more the financial sector has manoeuvred itself into a position of super-profitability. Over the 2000s US banks as a group reported returns on equity of more than 12 per cent (and Wall Street banks sometimes twice as much). The share of financial sector profits in total corporate profits surged from about 18 per cent in 1980–90 to 36 per cent in 2001–06.

Senior employees in finance have enjoyed a magnificent remuneration premium compared to those in comparable professions. A study of Harvard graduates found that those who worked in finance received, over the 2000s, remuneration almost 200 per cent higher than Harvard graduates from the same cohort who went into other professions such as law, engineering and medicine, holding other things such as length of education constant; whereas in 1950–80 finance received no premium (Golding and Katz, 2008). In the 25 highest fee-charging US-based hedge funds, the CEOs earned an average of US\$250 million in 2005.

Many governments, notably those of the United Kingdom and the United States, home to the two major financial centres, became beholden to the financial industry more than to any other (except possibly defence). They relied on it for political support, election campaign financing and tax revenues; and were readily persuaded by the self-serving idea that financial markets are efficient and self-adjusting (as distinct from self-destructing), hence that “light-touch regulation” is sufficient. This, combined with their mood of self-congratulation at engineering “the great moderation” (non-inflationary growth with high employment), encouraged them to signal that they would use their deep tax pockets to bail out large financial organizations which made ill-judged investment decisions, creating a largely unnoticed danger of “moral hazard”.

Financiers became confident that “We won’t face the downside if we screw up”. So when they did stress tests for their organizations they modelled only *modest* levels of stress, reasoning that in the event of a *severe* stress, as one British banker related, “the authorities would have to step in anyway to save a bank and others suffering a similar plight”.<sup>4</sup>

Given that interest rates were low and that GDP was growing at only around 3 per cent, regulators should have noticed that consistent returns of more than 12 per cent meant excessive leverage or insufficient cushions of safety against risky assets. (Irish regulators should equally have noticed that private-sector credit growing by 30 per cent in 2006 and another 20 per cent in 2007 signalled a bubble.) By failing to act, regulators are directly implicated in the fate of families up and down the Atlantic world who are paying the bankers’ losses through rising taxes, shabbier public services and higher unemployment.

Not only was national regulation ineffective in keeping finance in check, global regulation (such as the Basel rules) was even less effective, or even counterproductive; and Europe put in place little effective cross-border financial regulation.

The effort at a game-changing “Great Re-regulation” began in late 2008, intensified in 2009, and morphed into an attempt at the “Great Revenge”.

4. Andrew G. Haldane, Executive Director for Financial Stability, Bank of England (see Haldane, 2009).

From across the political spectrum – from Gordon Brown and Barack Obama, from Angela Merkel and Nicolas Sarkozy, and from central banks and the International Monetary Fund (IMF) – came calls for the banks to be reined in. But by late 2010 it looked as though the Great Re-regulation had laboured to produce ... the “Great Escape” (Authers, 2010). In the two years since the peak of the financial crisis the US Government has brought not one criminal case against a senior financial executive; it shrinks from taking on big companies, and readily buys the “dumb-but-not-venal” defence (Sorkin, 2010). For the most part, the banks have succeeded in blocking the imposition of significant constraints on their behaviour beyond those already in place before the crisis, at the same time as the investment banks and hedge funds have resumed making giant profits.

Even the Icelandic bankers are now talking of a return of good times, and resuming the practice of taking prospective clients on no-expenses-spared salmon-fishing expeditions and trips abroad to see English Premier League football matches in VIP lounges (trust- and obligation-building practices which long substituted for close examination of the companies they were buying with money they lent to themselves).<sup>5</sup>

As for tighter global rules, the initial enthusiasm has run into the sand (Davies, 2010). The *Financial Times* columnist Philip Stephens (2010) concludes that “three years on, things are much as they were – except that most of us are poorer. The [financial] markets rule [again].” We remain vulnerable to an array of banks which are too big to fail and too big to save.

In the United States the overhaul of financial regulations approved by the Senate in July 2010 did make some small improvements. These included mechanisms for winding up banks in trouble, and the requirement that derivatives be traded on exchanges, which makes the derivatives market more transparent and makes the job of the regulator easier. The US Central Bank has issued broad guidelines on bankers’ bonuses, which include the “radical” recommendation that a portion of any bonus should be deferred and that *guaranteed* bonuses over several years should not be paid.

But the new Republican majority in the House of Representatives is trying to blunt some of the legislation approved before the November elections. It intends to cut the budgets of supervisory agencies such as the Securities Exchange Commission, and to block appointees to the supervisory agencies and to the Treasury whom the finance industry considers hostile. As the president of the Consumer Bankers Association said just before the

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5. The Icelandic bankers are boosted by confidence that they will not be prosecuted. The special prosecutor, now with a team of 80, has worked for two years and brought just one prosecution, of a minor player. The bankers believe that the Government has concluded that they are too important to jail and is offering them the deal of investing their ill-gotten gains (now hidden off-shore) in the Icelandic energy sector in return for foot-dragging on the prosecution (Wade and Sigurgeirsdottir, 2010; Wade, 2009a).



election, “At this juncture, gridlock is good. It’s time we take a breather from all the excess of regulation and congressional legislation” (Schwartz, 2010).

The European Union has finally, after months of haggling among its Member States and its different organizations, agreed on a new financial regulatory framework. The verdict of one expert on the new framework is: “It should work slightly better [than the current one]. Maybe” (Briançon, 2010).

The *Financial Times*’ Philip Stephens says about the changes to the US and European regulatory frameworks: “Worthwhile as they are, such measures look like tinkering when set against the capacity of capital markets to wreak economic havoc” (Stephens, 2010a).

The key weakness of the UK, US, and European Union’s new regulations is that they do not tackle the most important issues of all: ensuring that no banks are too big and too interconnected to be allowed to fail, and that banks do not again over-leverage. They kicked the latter issue up to the Basel Committee on Banking Supervision, which includes representatives of 27 countries.

### Basel III

The Basel Committee issued guidelines in mid-2010, known as Basel III, which say that banks should be required to raise the amount of high-quality capital (their own shares and retained earnings) they hold in reserves relative to their risk-adjusted assets from the current 2 per cent (under Basel II guidelines) to 4.5 per cent; and also hold an additional buffer of 2.5 per cent of risk-adjusted assets, such that banks whose capital falls within this buffer should face restrictions on paying dividends and discretionary bonuses.<sup>6</sup>

In the negotiations between the Basel Committee Member States, the United Kingdom, United States and Switzerland – homes of the largest developed economy banks and the countries with most to lose if another crisis hits – wanted higher capital ratios. But opposition from many European governments and the Japanese Government ensured that the rules are not nearly as tough as they should be.

The *Financial Times* columnist Martin Wolf summarizes the result:

To celebrate the second anniversary of the fall of Lehman, the mountain of Basel has laboured mightily and brought forth a mouse. Needless to say, the banking industry will insist the mouse is a tiger about to gobble up the world economy. Such special pleading – of which this pampered industry is a master – should be ignored: withdrawing incentives for reckless behaviour is not a cost to society; it is costly to the beneficiaries. The latter must

6. For the deep politics behind the Basel Committee, see Lall (2010).

not be confused with the former. *The world needs a smaller and safer banking industry.* The defect of the new rules is that they will fail to deliver this. (Wolf, 2010c, p. 13, emphasis added)

What are the main problems? First, the new capital ratios are still so low that most banks can easily meet them already (including about 45 of the 50 biggest European banks). Incredibly enough, the ratios were set by looking at the losses banks experienced in the current crisis – yet those losses were kept artificially low by massive taxpayer bailouts. *So the new ratios are safe only if investors are confident that governments will again bail out creditors in a crisis and put the losses onto taxpayers.* The ratios allow banks again to become so highly leveraged that it would not take much of a disaster to bring them close enough to insolvency to panic uninsured creditors. To quote Martin Wolf, “We might think of the new requirements as a ‘capital inadequacy ratio.’”

Second, the target ratios do not have to be met until 2019, in order to give the banks lots of time to adjust. Yet if a bank is undercapitalized now it should be put on a much faster timetable.

Third, the new rules do not ensure that banks have sufficient liquidity – resources that can be quickly converted into cash, even in a panic. The liquidity requirements remain to be defined.

Fourth, the rules say banks should build up capital in good times, so that it would be available as a cushion in bad times; but the Basel Committee could reach no agreement on something more precise.

### Financial industry fight-back

The financial industry – the most subsidized industry in the world by far, thanks to its almost unlimited access to public revenues in bad times – is mounting determined resistance even to many of the measures which Philip Stephens calls “tinkering”. Its representatives argue that the industry has already made the necessary changes to stabilize its firms, so more regulation is not necessary. Moreover, more regulation is not desirable, because it would put economic recovery in jeopardy. Tougher rules would cut 3 per cent off economic growth over the next five years across the United States, the euro zone and Japan, and cost ten million jobs, they say. “Every dollar of [required] capital is one less dollar working in the economy,” according to the Financial Services Roundtable, an organization of large US financial organizations (quoted in Norris, 2010, p. 19).

It is not hard to guess why the banks have been so opposed to lower ceilings on leverage and significant increases in their capital reserves, and why they are keen to have us forget that their undercapitalization got us into the boom-and-bust cycle in the first place. Ensuring that banks do not over-leverage and do hold more capital in reserve, and that regulators have the

tools to govern them, would cut bank profits during the next good times. Even today, with some banks again making big profits, “there are plenty of signs that some banks are still ignoring the spirit of the new rules” and again paying giant bonuses – circumventing the ban on guaranteed multi-year bonuses by, for example, offering employees loans that are forgiven if they stay with the firm for several more years (Larsen, 2010).

If it is not hard to guess why the banks have been so opposed to re-regulation, the slightly harder question is why the banks have been so successful in blocking it – in converting the Great Re-regulation into the Great Escape? The answers were sketched earlier, but deserve elaboration.

First, the banking industry has raised fears about the consequences of tougher regulation – fears of dire effects on growth and employment; fears of “regulatory arbitrage” in the form of moving headquarters to another country; fears of regulatory arbitrage in the form of moving financial activity out of regulated banks and into unregulated “shadow banks”, as happened in the upswing of the past cycle.

The second reason for the banks’ success is that the banking lobby is one of the most powerful lobby groups in the United States. There are five registered bank lobbyists for every member of Congress, more than for any other sector. Congressmen and women depend heavily on payments from the financial sector for their re-election campaigns, and they know it is generally a bad idea to go against the banks – or rather, a bad idea to *act* against the banks as distinct from *talk* against the banks.

Third, US politics has become extremely polarized along party lines, such that Republican members of Congress almost never support a Democratic party proposal, and vice versa. During the Obama Administration the Republicans have mounted a particularly effective blockade under the slogan, “Hell, no”, one of the consequences thereof being that the financial regulations were continually watered down as they proceeded through Congress.

### Hayek’s revenge

The Republican blockage rests on a resurgence of “anti-government” sentiment in the United States, especially anti-federal government. One of its strangest aspects is the return to right-wing favour of Friedrich Hayek’s book *The Road to Serfdom*. As of early 2010 the book stood at number 241 on the Amazon bestsellers list: not bad for a book first published in 1944. Hayek’s thinking was rooted in the liberal view that government ought to leave individuals to make their own choices because they know best what they want (a view formed by eighteenth-century philosophers who had no understanding of the social influences on people’s tastes and preferences), and rooted in reaction against the experience of Fascism and Stalinism. His book warned that state infringements of economic freedom-to-do-what-the-individual-wants, such as

the Beveridge welfare state, put the society on the slippery slope to political serfdom. Its current popularity stems from boosts by conservative “thinkers” such as Glen Beck and Rush Limbaugh, who tell their listeners that *The Road to Serfdom* is a roadmap to what the Obama administration is doing. They claim that Obama’s health-care reform, the bank bailouts, and just about everything else the administration has tried to do (excepting military adventures) constitute rising “government intervention” in the economy; and that government restriction of economic freedom leads more or less inevitably to restriction of political freedom. In Rush Limbaugh’s words, “Friedrich von Hayek brilliantly laid it right out. It’s all about power. It’s all about control, and that’s what Obama’s about” (quoted in Farrant and McPhail, 2010).

The fact that the Beck–Limbaugh version of Hayek fails just about every empirical test one can think of has not stopped many millions of Americans from believing the argument and using it to fuel up the McCarthyite tendencies of the Tea Party movement and the Republican right.

The bottom line is that the opportunity to stamp on the practices that led to the crisis has been lost, for the most part. The post-crisis financial reforms in the United Kingdom and United States seem to have done little to reduce vulnerability to another euphoric bout of “This time is different”. We – meaning most western governments, the European regulatory bodies and the IMF – are in the position of having had a bad crash due to a badly designed car, and are now climbing into a repaired version of the same vehicle for another drive (Blyth, forthcoming).

The G20 leaders’ meeting in Seoul in November 2010 approved the Basel Committee’s Basel III “mouse-like” guidelines. Meanwhile, governments continue to step in to guarantee their banks’ debts, turning private losses into public obligations and protecting most private investors in the banks from sharing in the losses. The German Government is proposing to establish a special resolution regime that would allow the regulator to impose a restructuring of the debt of failing banks, so that investors would carry some of the cost of their gambles. But proposals for investor “haircuts” can be easily marginalized by the argument that they would push up borrowing costs for banks and States at the very moment when this is hardest to bear.

**Prediction 2b.** *The next decade will see at least one major financial crisis affecting a large part of the world economy, because income distribution will remain highly polarized in the anglophone countries and in many developing countries, notably China, with the top 1 per cent accruing remuneration fifty times and more that of the median. Income polarization raises the level of financial fragility and the probability of financial crisis.*

The discussion so far has identified problems in the re-regulation of finance as one of the sources of the next big financial crash. But we should be wary

of following the standard diagnosis that the root cause of financial crisis lies in the structure and regulation of finance. When Jean-Claude Trichet, President of the European Central Bank, says that “the root cause of the crisis was a widespread undervaluation of risk”,<sup>7</sup> he begs the question of *why* financial organizations undervalued risk. To answer that question takes us away from the structure and regulation of finance, to the structure of income and wealth.<sup>8</sup>

The extraordinary growth over the past two decades of ordinary debt securities such as mortgages and of complex securities such as collateralized debt obligations (CDOs) cannot be explained from within the financial sector. Rather, their growth can be explained by the high and rising polarization of income in many countries. Organizations such as Goldman Sachs created a large supply of securities (many of which later turned out to be “toxic”) because they were responding to soaring demand for them. The demand came from those at the top of increasingly concentrated national income distributions looking for ways to store and multiply their wealth. Meanwhile the great mass of the population received stagnant incomes and sought to raise consumption through borrowing (in the spirit of Plautus). The two sides came together, with the rich accumulating more and more assets backed by loans to the rest of the population. In other words, the financial system produced vast quantities of securities not just because regulation was poor, but because of strong “external” pressure on it from the polarized income distribution. Governments obliged by making easy credit available in order to keep demand and employment up despite stagnant disposable incomes of the bulk of the population.

In the words of Michael Kumhof and Romain Ranciere (2010): “When ... the rich lend a large part of their added income to the poor and middle class, and when income inequality grows for several decades, debt-to-equity ratios increase sufficiently to raise the risk of a major crisis.”

In the United States income polarization has reached almost banana-republic levels. To put it in long-term perspective, the share of disposable income accruing to the top 1 per cent of US households rose through the 1920s to hit a peak of 22–23 per cent in 1929, then fell through the Great Depression, the Second World War, the Great Society, until it bottomed out at around 8–9 per cent in the mid-1970s. After 1980 it began to soar, to reach 22–23 per cent in 2006 (including capital gains), the same as the previous peak in 1929. During the Clinton administration of the 1990s the top 1 per cent received about 45 per cent of the increase in US disposable income; and

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7. Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Fifth ECB Central Banking Conference “The Euro at Ten: Lessons and Challenges”, Frankfurt, 13 November 2008, available at <http://www.ecb.int/press/key/speaker/pres/html/index.en.html>.

8. On the role of income polarization, see Wade (2009b, 2009c).

during the George W. Bush Administration of the 2000s the top 1 per cent received about 73 per cent of the increase (Palma, 2009; Wade, 2009b). This is not a misprint.

The United States now has the highest density of dollar billionaires in the world relative to population and the second highest relative to GDP (next to Saudi Arabia); about three times the European Union's density (Forbes Billionaires list, based on market values, February 2009).

Indeed, the top 1 per cent of Americans possesses more private net wealth than the bottom 90 per cent: 34 per cent as against 29 per cent. Even more remarkable, Argentina and the United States have swapped places in the inequality league. In the 1940s Argentina's top 1 per cent accrued about 20 per cent of incomes while America's accrued about half of that; by the 2000s the share of America's top 1 per cent exceeded Argentina's in the 1940s, while Argentina's had fallen to about 15 per cent (Kristof, 2010).

On the other hand, the real income of the median household increased by less than 10 per cent between 1990 and 2010, while GDP grew by 60 per cent. Over the 2000s between a quarter and a third of American children were living with one or no parents, in chaotic neighbourhoods with failing schools. The UNICEF assessment (2007) of the well-being of children in 21 industrialized countries placed the United States second to bottom, well below the third-to-bottom country, Hungary. The United Kingdom languished at the very bottom.

Meanwhile, China now has a heavier density of billionaires relative to GDP than the European Union, though it remains far below the United States. According to Forbes, mainland China and Hong Kong (China) had 89 billionaires in early 2010, while Japan, with an economy almost as large and average income several times higher, had 22.

China and the United States are extreme examples of the general pattern. The large majority of the world's population lives in countries where income inequality has increased over the past two decades.

In the context of high and rising income inequality, strengthening financial regulation will not protect us from large financial crises – because income concentration at the top itself generates strong pressures on the system to create both high levels of debt relative to equity and large quantities of complex securities with high yield and high ratings. These pressures will continue to swamp regulatory systems both directly and indirectly through politics.

In any case, anything more than minor strengthening of financial regulation is unlikely in the United States because its politics has become so intensely polarized as to preclude sufficient cross-party agreement on ways to do it. The current extreme political polarization is not just a Tea Party-type reaction to the Obama Administration. It is driven by structural features of US society, particularly income and wealth polarization, such that income polarization and political polarization reinforce each other (McCarty, Poole

and Rosenthal, 2006).<sup>9</sup> Political polarization makes it unlikely that the United States will take a lead in introducing financial regulation that would effectively curb the banks.

**Prediction 2c.** *The next decade will see at least one major financial crisis affecting a large part of the world economy, because global payments imbalances will continue at levels where the associated capital flows keep the level of financial fragility dangerously high.*

“I would place the US current account [deficit] far down the list of imbalances to worry about,” declared Alan Greenspan, former chair of the US Federal Reserve, in 2007. He was expressing the same free-market ideology as Arthur Laffer, the conservative supply-side economist of the Reagan era, who assured the Icelandic business and libertarian community in late 2007 that Iceland’s fast economic growth with a large trade deficit and ballooning foreign debt were signs of success. “Iceland should be a model to the world,” he declared (Laffer, 2007).

Greenspan was correct that the financing of the US deficit had not by then proved difficult. Huge though it was (roughly the size of India’s GDP), external holders of US dollars had been willing to go on accumulating them, avoiding a panicky sell-off. But Greenspan ignored the correspondence between the external deficit and domestic debt. At the domestic end of the credit–debt system, domestic agents built up debt to levels that were unsustainable once house prices stopped rising. This is where the rupture occurred, not at the external end, exposing “the US conceit that its financial and regulatory system could withstand massive capital inflows on a sustained basis without any problems”, in the words of Carmen Reinhart and Kenneth Rogoff (2009, p. 213; see also Wade, 2009c).

The most serious gap in the international financial system is a mechanism for curbing payments imbalances without putting all the adjustment pressure on the deficit countries. The market for foreign exchange is barely fulfilling this function. It is driven more by speculative capital flows than by trade flows, and it moves exchange rates in crazy directions, like drunken air

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9. Recent polls suggest that the polarization is now more driven by partisanship than by ideology, in the sense that respondents tend to approve of a given policy (such as body-scanning at airports) when sponsored by “their” side and oppose the same policy when sponsored by the other side; and to view the performance of the economy favourably when their side is in power (the deficit has shrunk) and unfavourably when the other side is in power (the deficit has increased), even when the external facts are different. In 2006, during the Bush (Republican) Administration, Gallup asked the public whether the Government posed an “immediate threat” to Americans. Twenty-one per cent of Republicans to 57 per cent of Democrats said yes. In 2010, during the Obama (Democrat) Administration, 66 per cent of Republicans to 21 per cent of Democrats said yes (Douthat, 2010b).

traffic controllers. Countries running large deficits and high inflation may experience currency *appreciation*, as “carry trade” investors seek to profit from both the high interest rates and the prospect of further currency appreciation – the story in much of Eastern Europe and also, especially, in Iceland (Wade and Sigurgeirsdottir, 2010). Meanwhile, some governments peg their exchange rate to that of their main export market, even as they accumulate large external surpluses and large reserves, partly so as to substitute for World Trade Organization (WTO)-prohibited tariffs, quantitative restrictions and other industrial policies.

In contrast to trade, in which governments have shared sovereignty to create WTO trade rules and a dispute settlement mechanism, governments jealously protect their currency markets from external discipline. The United States, in particular, shows no interest in sponsoring a switch from the US dollar as the main reserve currency to an accounting currency linked to a basket of all the major currencies, in which countries would accumulate reserves. Without some major institutional change of this kind, the world economy will continue to experience large external deficits and surpluses, as well as destabilizing capital flows.

## Conclusions

I have suggested, first, that the West is likely to experience several more years of slow and erratic growth; and second, that another major financial crisis within a decade is quite possible. The first prediction rests particularly on (a) the size of the existing mountain of financial claims on income relative to income flows; (b) the determination of European governments, now joined by the US Government under the influence of the new Congress, to press full steam ahead into fiscal austerity – all saying they will rely on export growth to offset the fall in domestic demand, as though they had not heard of the fallacy of composition; and (c) the determination of countries running external surpluses to sustain those surpluses, making it more difficult for deficit countries to boost their exports.

The second prediction rests on the failure to push through reforms to finance which would stamp on the practices that produced the current crisis, and to change the incentive structure facing the banks with its built-in bias towards “moral hazard”. It also rests on factors beyond the financial sector. The latter include high “top end” income and wealth inequalities, which generate a high and rising demand for these practices (in the form of complex financial instruments in which the wealthy can store and multiple their wealth). They also include persistent payments imbalances and their associated capital flows. The combination of income concentration at the top and large payments imbalances is likely to swamp the stabilizing effects of regulatory bulwarks.



As if these forces were not enough, there is also the prospect of the disintegration of the eurozone, as repeated “rescues” of the peripheral countries fail and as Germany and the IMF impose impossibly severe fiscal policies on the periphery (an immediate fiscal tightening in Greece of 7 per cent of GDP, for example). A break-up of the eurozone, whether partially or wholly, would disrupt global growth for several years.

It is not all bad news. The OECD’s abrupt U-turn in early September 2010 in favour of sustaining the fiscal stimulus may help to persuade governments to moderate their cutting plans.

The Basel Committee’s recommendations on higher global capital standards, also announced in early September 2010, may help to slim bank profits and make asset bubbles less likely – provided regulators make sure that the rules are implemented swiftly. But as Martin Wolf suggests, the new capital adequacy standards will help only a little, as compared with equity requirements of 20 to 30 per cent which Wolf considers should be the target. Indeed, one can argue that banks will be safe only when they raise *most* of their capital from equity, not debt, and that anything short of this is an invitation to crisis and taxpayer-financed bailouts (under the banner of “there is no alternative to a bailout”). To the objection that shifting from debt to equity would raise the cost of credit, the counter is that that is precisely the point: credit should be priced to reflect risk more accurately, and the size of the financial sector in the anglophone economies and the world at large should be shrunk.

Another positive result might be that the dysfunctions of global organizations such as the G20 and the IMF Committee induce the growth of compensating regional governance mechanisms, such as the Chiang Mai Initiative (CMI).<sup>10</sup> This would fortify the principle of subsidiarity and dilute the assumption that regulatory harmonization *on a global scale* is optimal (Rottier and Veron, 2010; Wade, 2008).

Finally, the collapse of 2007–09 could be interpreted as the harbinger of a two-to-three decade period of stable and globally dispersed growth as the family of information and communication technologies developed after 1970 is fully deployed around the world (Perez, 2009). In this interpretation the period since the information and communication breakthroughs of the 1970s is the fifth major technology surge in the capitalist world economy since the mechanization and water transport technologies of the late eighteenth century. Each technology surge has displayed a similar underlying structure. The first phase is a turbulent period of installation lasting two to three decades, during which finance becomes increasingly powerful in directing investment

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10. The CMI was a swap arrangement among the ASEAN + 3 (China, Japan, Republic of Korea) established in the wake of the East Asian financial crisis of 1997. It was largely symbolic, because the swap lines were too small in relation to plausible currency crises. But the 2008 crisis prompted an extension, the Chiang Mai Initiative Multilateralization (CMIM), which comes close to a regional monetary fund (Akuz, 2009; Wade and Vestergaard, 2010).

into the new sectors; but over this period financiers move from seeking dividends to seeking capital gains, creating a major bubble, which ends with bubble collapse. In the wake of the collapse, the second phase is a period when the socioeconomic framework is reformed, finance is curbed, and production capital drives the full deployment of the major technology until its profit opportunities are exhausted. At some later point a new technology family appears (such as steam and railways around 1830, then steel and heavy engineering in the 1870s), and the cycle begins again. Finance capital moves out of the exhausted technologies to support entrepreneurs of technologies which have been in gestation for years but have been restrained by the institutional framework around the old technologies, and the owners and managers of production capital replace those of finance in the driving seat.

In this interpretation, the twin collapses of the Internet bubble (2000–01) and the liquidity bubble (2007–09) may pave the way for a new long-run growth era as the information technologies combine with technologies of low carbon, public transport, and lifetime education and health care to provide profitable investments around the world. However, so far there is no sign that finance has yet been weaned off its addiction to essentially speculative investment (seeking short-term capital gains), or that it will be downsized and more closely regulated, or that its leadership is being challenged by the global information companies. Perhaps the financialization of the economy has reached the point where a third crisis would be needed to break the grip of finance and release another production surge.

### The *Titanic* analogy

These several qualifications are slender threads with which to dispel the *Titanic* analogy. What is especially alarming is that the present consensus around spending cuts constitutes not ignorance but *unlearning* of key ideas of Keynesian economics. One might expect that the neoliberal ideas which have shaped economic policy in the West for more than two decades would have crash-landed on facts and common sense about the current crisis; but the signs are that they retain much of their hold over policy-makers and the economics profession, only slightly softened at the edges.<sup>11</sup>

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11. If polls had been taken of policy-makers and economists in, say, 2007 and 2010 they would probably show a fall between those years in the proportion of respondents agreeing with little qualification to propositions about the virtues of free capital movements and the self-regulating tendencies of financial markets. As told by the *Financial Times* Lex column:

For much of the past decade, emerging market policy-makers were relatively relaxed about the movement of capital across borders. They would cheerily send capital on its way so long as the entry or exit papers were in order. *The authorities are now a lot more guarded.* The 2008–09 crisis was a reminder of the fickleness of foreign investment. Violent currency swings showed the difficulty of dealing with more or less unchecked

This is a surprise, on the face of it. Centre-left champions can produce ample evidence with which to debunk key ideas of the centre-right (not to mention mainstream economics) – such as the efficient financial markets hypothesis, and the idea that free capital movement is a good rule for all, and the belief that anyone who worries about income polarization is merely practising the politics of envy. This debunking should have mass appeal, because voters have just lived through the worst crisis in western capitalism in the 70 years since the 1930s, they are enraged at the bankers, and they are angry at governments for the rush to fiscal austerity – at least when the austerity hits education, health and defence. Meanwhile, centre-right governments in Europe are in a mess: in Italy Berlusconi's rightwing coalition has split; in Germany Angela Merkel's Christian Democrats are adrift; in France Nicolas Sarkozy is driving all over the road.

Yet in Canada, continental Europe, the United Kingdom and the United States, progressive politics has been in retreat, unable to seize the advantage. Fringe parties on right and left have made electoral gains. America is rife with wild and crazy sentiments, such as the belief that “Jews” were responsible for the financial crisis, affirmed by 32 per cent of registered Democrats; that President Obama is secretly a Muslim, affirmed by nearly 20 per cent of respondents in national polls; and that it is “definitely true” or “probably true” that “Barack Obama sympathizes with the goals of Islamic fundamentalists who want to impose Islamic law around the world”, affirmed by 52 per cent of Republicans in a recent Newsweek poll (Douthat, 2010a). Political parties are stoking up voters' fears with the same logic as the Salem witchcraft trials of seventeenth-century New England.

### Protection from uncertainty versus fear of government intervention

Behind these trends in western politics lies the collision of two powerful impulses (Stephens, 2010b). First, voters want government to protect them from physical, economic and identity uncertainties. Even in 2007, well before the

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flows. Central banks have to fight exchange-rate appreciation on the way in, depreciation on the way out ... There is growing evidence that judicious controls can tame volatility without threatening the broader economy.

Take Taiwan. Late last year ... the central bank governor, making clear his distaste for “unbridled” international capital flows, clamped down on foreign portfolio investors. So far this year, net inflows into equities are down almost 90 per cent. But this has not had a catastrophic effect on stock prices... Moreover, it seems to have stabilized the Taiwan dollar ... And investors' enthusiasm for the cross-strait growth story is apparently undimmed.

Other emerging countries will have to take note. Capital is heading Asia's way, whether it wants it or not. Investors should realise that when it comes to curbing excess, authorities would rather be too successful than not successful enough. (Lex, “Capital mobility”, 19 Sep. 2010, emphasis added)

onset of the current crisis, a *Financial Times*/Harris poll across the western world found that citizens were looking to government to cushion the blows they perceived as coming from the liberalization of their economies to trade with developing countries. In France, Spain, the United Kingdom and the United States respondents were three times more likely to say globalization was having a negative rather than positive effect on their countries. The country with the smallest majority against globalization was Germany, with its large export base (Giles, 2007).

The second impulse, however, is that voters are suspicious of government “intervention”. Slogans such as “over-mighty government”, or in Prime Minister David Cameron’s language, “big society, not big government”, elicit mass support. In the United States the visceral, primitive form of free-market populism now rooted in the conservative movement has emboldened Republicans to block just about every Obama proposal.

### Plutocratic politics

The causes of these two opposed impulses in the western mass public are less clear. But they are surely related to the widening class gap between a plutocracy and the rest, and to the responsiveness of democratic politics and the media to the preferences of those in the top few percentiles of the income distribution. The US financial industry, having been rescued by Obama’s policies, is determined to unseat the Government, cut taxes, roll back financial regulation and health-care reform and boost its own remuneration still more – as in the case of AIG, the reckless insurance giant, which having been saved by Treasury loans proceeded to pay out US\$165 million in executive bonuses and funnel millions of dollars to the Republican party (Egan, 2010). The conservative populist movement is being promoted with funding, organization and ideas by super-elites such as the billionaire Koch brothers, who seek to use the movement to secure legislative support for less tax and less regulation. They persuade its supporters that the movement is fighting elite power, in what must be the biggest exercise in false consciousness the western world has ever seen (Monbiot, 2010). They supply the masses with a narrative of a conspiracy against the American way of life, into which is slotted public health care, efforts to forestall climate change, support for the United Nations, and many other government “interventions”.

No doubt my argument is oversimplified, and it may be dismissed as too close to conspiracy theory. But pay attention to the following statement by Sir Alan Budd, a long-serving UK Treasury official who became Mrs Thatcher’s chief economic adviser:

The Thatcher government never believed for a moment that [monetarism] was the correct way to bring down inflation. They did however see that

this would be a very good way to raise unemployment. And raising unemployment was an extremely desirable way of reducing the strength of the working classes ... What was engineered – in Marxist terms – was a crisis of capitalism which re-created the reserve army of labour, and has allowed the capitalists to make high profits ever since. (Quoted in Cohen, 2003)

In the post-war decades up to the 1970s, when the idea of a social compact made sense and income distribution was substantially more equal than in the 1920s or in the 1980s and beyond, governments gave high priority to full employment and used fiscal, monetary and occasionally even incomes policies to pursue this objective, such that average wages increased in line with productivity. Aggregate demand remained high, unemployment remained low.

This whole complex was broken in the 1980s and has remained broken ever since: governments have given priority to very low inflation, and have sought to make labour markets “flexible” by means of institutional changes which lower the relative price of labour and hold wage growth below productivity growth. Unemployment rates have remained much higher than before. Some of the reasons are related to technological change and “globalization”, which brought intensified competition between many more national labour forces; and some to the increased participation of women in the labour force. But the class project described by Budd, of breaking the social compact and shifting the distribution of power and income upwards towards the top end, is also an important part of the story. It worked brilliantly to keep income flowing disproportionately to the top in the United Kingdom and United States. (In the year to June 2010, the average director’s remuneration in FTSE 100 companies increased by 55 per cent, the median director’s remuneration by 23 per cent, while average earnings for the rest of the population increased by 1.5 per cent.) At the same time, the United Kingdom and United States have the lowest rates of intergenerational social mobility of the continental European and North American societies; they are progressing from class societies towards caste.

### The West’s fear and China’s swagger

If the widening and solidifying gap between the plutocracy and the rest is one main cause of the opposing impulses in western politics, another is the gnawing fear in the West that its best days are over, that we are at the beginning of a long decline in western primacy in industry, technology and scientific innovation, and a parallel decline in western dominance of international politics. The fear strikes at a bedrock of western identity ever since the Enlightenment and the Industrial Revolution, that agents of western civilization should rule the world and bring the rest of the world into harmony with their values.

This is the fear. At the same time, the resurgent American conservatives are united around belief in the exceptional virtue and uniquely benign role of the United States in the world. The belief encourages the presumption that the United States should enjoy the benefits that flow from others' adherence to the rules without the inconvenience of having to abide by those rules itself, and the presumption that the United States should not accept the constraints on its power posed by the rise of new power centres. With Republicans back in control of the House of Representatives, US foreign policy is likely to be pushed back towards the aggressive, self-righteous, self-pitying foreign policy of the George W. Bush Administration, based on "coalitions of the willing". Meanwhile, the Chinese Government responds increasingly haughtily to suggestions from other States that it should behave differently (on currency, human rights, and most issues in between) – in the same manner as the British Government during its imperial heyday. This China–United States combination is not a promising basis for forging multilateral agreements on global issues, whether about climate change, trade, financial regulation, internal rebalancing of savings and demand or external rebalancing of payments (Wade, forthcoming).

As social scientists we can at least identify key questions whose answers will shape how these contrary impulses play out. Can the West retain its concentration of the high value-added parts of global production chains, perhaps by continuing to rig the world trade regime in its favour (Wade, 2003)? Can the West retain its privileged access to the best sites for oil and minerals (including Afghanistan and Iraq)? Will the United States manage to correct its "Great Misallocation" in construction and finance, and develop new export industries? Will the American Right be able to keep goading the population into hatred of some "enemy" – terrorists, China, Muslims, liberals, "Black Muslim" "Socialist" President Obama – to the point where more warfare becomes electorally acceptable, even to the point of knocking out the financial claims and productive capacities of US "rivals" in the hope of preparing the ground for another period of fast US economic growth? Will the plutocracy be able to sustain its position of concentrated and largely unaccountable power and use it to obtain deeper public spending cuts and more divisive policies (Wedel, 2009); or will more populist forces succeed in engineering a radical devaluation of monetary assets, including those of the plutocracy, by a bout of high inflation?

How can social democrats mobilize enough support to secure public office against the efforts of the Right to bring people out into the streets where visceral simplifications reign? How can policies of "embedded liberalism" regain legitimacy? Will a more legitimate successor to the current G20 emerge as a "steering committee" for the world economy? Will it or some other body be able to engineer the crucial move from the US dollar as the main reserve currency to an accounting currency based on a basket of major currencies, and couple it with penalties on both surpluses and deficits?

How will the various dysfunctions in the established western powers, added to the rapid ageing of their populations, affect the opportunities for rising powers such as Brazil, China and India to substantially lower the gaps in income, technology and human capabilities between them and the West? When will the Chinese Government soften its assertion of its own national interests and seek compromise with those of others? Will China become old before it has become rich, with the result that most of its economy remains locked in a semi-peripheral role in the world economy, punctuated with islands of high-tech opulence (“cathedrals in the desert”)? Will this be India’s later fate too?

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# Redistribution, global imbalances and the financial and economic crisis

*The case for a Keynesian New Deal\**

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\* This paper draws on a research project at the Berlin School of Economics and Law devoted to the role of distribution for the financial and economic crisis (Hein, 2010a). For excellent research assistance I would like to thank Matthias Mundt. I have also benefited from helpful comments by Nina Dodig, Marc Lavoie, Achim Truger and an anonymous referee, for which I am very grateful. Remaining errors are, of course, exclusively mine.

The world economy is still suffering from its most severe crisis since the Great Depression of the late 1920s to the early 1930s. On the one hand, the present mess is caused by a financial crisis which started with the collapse of the subprime mortgage market in the United States in summer 2007, then exacerbated with the breakdown of Lehman Brothers Holdings Inc. in September 2008 and finally reached another peak with the euro crisis in early to mid-2010. Under the conditions of deregulated and liberalized international financial markets, the financial crisis rapidly spread all over the world. On the other hand, we are witnessing a far more fundamental disruption which started with an economic downswing in the United States well before the financial crisis. The financial crisis and the more widespread economic crisis have reinforced each other, hitting the world economy with a decline in real GDP in 2009 – something not seen for generations. Major regions around the world are only slowly recovering from this decline, in particular the euro area, Japan and the United Kingdom (IMF, 2010). By the end of 2010, GDP and employment remained well below the levels which could have been attained on the pre-crisis growth path, and major areas of the world economy were threatened with a serious medium-term risk of deflationary stagnation (Hein and Truger, 2010). Therefore, in what follows we consider the crisis which began in 2007 as still unresolved.

The severity of the present crisis cannot be understood without examining the medium- to long-term developments in the world economy since the early 1980s. Three major long-term causes of the crisis can be identified: inefficient regulation of financial markets, increasing inequality in the distribution of income, and rising imbalances at the global (and at the euro area) level.<sup>1</sup> These developments have been dominated by the policies aimed at deregulation of labour markets, reduction of government intervention in the market economy and of government demand management, redistribution of income from (lower) wages to profits and top management salaries, and deregulation and liberalization of national and international financial markets. In what follows, we will call this broad policy stance “neo-liberalism”, describing the policies implemented – to different degrees in different developed capitalist economies – since the early 1980s.

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1. On global imbalances and unequal distribution as causes of the present crisis, on top of widely accepted inefficient regulation of the financial sector, see, with different emphasis, Bibow (2008); Hein and Truger (2010, forthcoming); Horn et al. (2009); Fitoussi and Stiglitz (2009); Sapir (2009); UNCTAD (2009); Wade (2009). In particular, see the early pre-crisis analysis by van Treeck, Hein and Dünhaupt (2007) focusing on the effects of “financialization” on distribution, aggregate demand, global imbalances and the subsequent potential for instability. For a review of the changes in worldwide financial markets and related imbalances which fed the financial crisis, see Guttman (2009).

This paper focuses on the changes in distribution triggered by “finance-dominated capitalism”<sup>2</sup> embedded in the “neo-liberal” policy stance in effect since the early 1980s, on the global and regional imbalances underlying the present financial and economic crisis, and on the economic policy requirement emanating from our analysis of the deeper causes of the crisis.

The paper is organized as follows: first, we examine the three dimensions of redistribution in the course of “financialization” and “neo-liberalism” since the early 1980s: functional distribution, personal distribution and the evolution of top incomes. The following section addresses the relationship between redistribution and regional (euro area-wide) and global current account imbalances. Next, we draw the economic policy conclusions from our analysis with respect to the role of distribution or incomes policies within an income-led recovery strategy or a “Keynesian New Deal at the global and the European levels”, designed to overcome the three main sources of the present crisis, i.e. inefficient regulation of the financial sector, increasing inequality of income distribution and imbalances at global and regional (euro area) levels. Finally, we present a summary and conclusions.

### **Redistribution trends in the period of neo-liberalism and financialization since the early 1980s**

The neo-liberal period since the early 1980s and the emergence of finance-dominated capitalism in major OECD countries have been associated with a massive redistribution of income.

With respect to functional income distribution we observe a massive redistribution at the expense of labour in favour of broad capital income. The labour income share, as a measure taken from national accounts and corrected for the changes in the composition of employment regarding employees and self-employed,<sup>3</sup> has shown a downtrend since the early 1980s in the developed economies considered here, with cyclical fluctuations due to the well-known countercyclical properties of the labour income share. In order to eliminate cyclical fluctuations of the labour income share, we have calculated cyclical averages for the three trade cycles from the early 1980s until 2008 (table 1). On average throughout the cycle, the labour income share has fallen in all countries in our data set save Portugal, from the first cycle (from the early 1980s to the early 1990s) to the third cycle (from the

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2. For (post-) Keynesian views on “financialization” or “finance-dominated capitalism”, see Hein (2010b); Hein and van Treeck (2010); Palley (2008); Stockhammer (2008); van Treeck (2009).

3. The labour income share is given by the compensation per employee divided by GDP at factor costs per person employed. The European Commission (2010), from which our data are taken, calls this the “adjusted wage share”.

early 2000s until 2008). The fall has been most substantial in Austria and Ireland with more than 10 percentage points of GDP at factor costs, and in France, Greece, Japan and Spain with more than 5 percentage points of GDP. In Belgium, Germany, Italy, the Netherlands, Sweden, the United Kingdom and the United States the labour income share has fallen by less than 5 percentage points of GDP at factor costs.

Financialization and neo-liberalism have had a negative effect on the share of direct labour in national income via three main channels (Hein, 2010a). First, the sectoral composition of the economy has changed in favour of high-profit-share financial corporations, at the expense of the non-financial corporate sector and the government sector with lower or zero profit shares. Second, overhead costs have increased, in particular top management earnings and interest payments, and profit claims imposed on the corporate sector by shareholders. This has caused a rise in the mark-up on direct unit labour costs in pricing of firms in incompletely competitive markets and the share of labour income to fall, because the mark-up has to cover overhead costs and profit claims. Third, the bargaining power of workers and trade unions has been weakened, triggered by shareholder value orientation and short-term managerial vision. This has enhanced the relevance of the financial sector, where trade union activity is weak, in comparison to the non-financial and the government sector where trade unions are stronger. Also increased are the

**Table 1. Labour income share as a percentage of GDP at current factor costs, average values over the trade cycle, early 1980s–2008**

	(1) Early 1980s– early 1990s	(2) Early 1990s – early 2000s	(3) Early 2000s – 2008	Change (3–1), percentage points
Austria	75.66	70.74	65.20	–10.46
Belgium	70.63	<b>70.74</b>	69.16	–1.47
France	71.44	66.88	65.91	–5.53
Germany	67.11	66.04	63.34	–3.77
Greece <sup>a</sup>	67.26	62.00	60.60	–6.66
Ireland	70.34	60.90	55.72	–14.61
Italy	68.74	67.21	65.57	–3.17
Japan <sup>a</sup>	72.38	70.47	65.75	–6.64
Netherlands	68.74	67.21	65.57	–3.17
Portugal	65.73	<b>70.60</b>	<b>71.10</b>	<b>5.37</b>
Spain	68.32	66.13	62.41	–5.91
Sweden	71.65	67.04	<b>69.16</b>	–2.48
United Kingdom	72.79	71.99	70.67	–2.12
United States	68.20	67.12	65.79	–2.41

Notes: The labour income share is given by the compensation per employee divided by GDP at factor costs per person employed. The beginning of a trade cycle is given by a local minimum of annual real GDP growth in the respective country. Figures in bold mean an increase relative to the value in the previous cycle or in the first cycle.

<sup>a</sup> Adjusted to fit the three-cycle pattern.

Source: European Commission (2010), author's calculations.

threat-effect of liberalization and globalization of finance and trade, deregulation of the labour market, and downsizing or abandonment of government demand management policies.

With respect to personal income distribution, increasing inequality can be observed in most of the countries in our data set from the mid-1980s until the mid-2000s. Taking the Gini coefficient as an indicator, this is true for the distribution of market income, with France and the Netherlands being exceptions (table 2).<sup>4</sup> In some countries this rise in inequality has been considerable: in Germany, Italy, Japan, Portugal and the United States the Gini coefficient has risen by 15 per cent or more. If we include redistribution via taxes and social policies by the State, Belgium, France, Greece, Ireland and Spain have not seen an increase in their Gini coefficient, with considerable declines recorded in France, Greece and Spain. The other countries, however, have also experienced rising inequality in disposable income in the period of neo-liberalism and finance-dominated capitalism. This increase was particularly pronounced in Austria, Germany, Italy, Sweden and the United States, where the after-tax Gini coefficient increased by more than 10 per cent. Although tax and social policies have reduced income inequality in all the countries under investigation, in most countries this has not been sufficient to prevent an increase in inequality over time. This is also the conclusion drawn by the OECD (2008) for a broader set of countries, and from the application of other measures of income inequality.

The pioneering analysis by Piketty and Saez (2003, 2006) has shown that the share of top incomes in national income has increased significantly in the United States since the early 1980s. Studies based on tax data, which have by now been extended to several other countries and reviewed in Atkinson, Piketty and Saez (2011), focus on the distribution of market income prior to taxation and government redistribution. Using the data supplied by Atkinson, Piketty and Saez (2011) we can observe the income-share evolution of the top 0.1 per cent in 11 countries in figures 1a–1d. The United Kingdom and the United States have seen an explosion of the highest income share since the early 1980s. Prior to the present crisis, this share had again reached the levels seen in the 1920s in the United States and in the late 1930s in the United Kingdom. In France, Germany, Italy, Ireland, Japan, the Netherlands, Portugal, Spain and Sweden, however, the share of the top 0.1 per cent has remained roughly constant or increased only slightly in the neo-liberal period, and has not returned to the high level prior to the Second World War. Note that the share of the top 0.1 per cent in Germany is substantially higher than in the other countries and has been

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4. OECD (2010) data used here are collected by the OECD from national sources. Data refer to cash income of households and are broken down to individuals. The income attributed to each individual is adjusted for household size, but does not distinguish between adults and children (OECD, 2008, pp. 41–47).

**Table 2. Gini coefficient before and after taxes**

*Gini coefficient before taxes*

Country	mid-1970s	mid-1980s	around 1990	mid-1990s	around 2000	mid-2000s	Change from mid-1980s to mid-2000s (%)
Austria	...	...	...	...	...	0.43	...
Belgium	...	0.45	...	0.47	0.46	0.49	8.89
France	...	0.52	0.51	0.48	0.50	0.48	<b>-7.69</b>
Germany	...	0.44	0.42	0.46	0.48	0.51	15.91
Greece	...	...	...	...	...	...	...
Ireland	...	...	...	...	0.43	0.42	...
Italy	...	0.42	0.44	0.51	0.52	0.56	33.33
Japan	...	0.35	...	0.40	0.43	0.44	25.71
Netherlands	0.42	0.47	0.47	0.48	0.42	0.42	<b>-10.64</b>
Portugal	0.46	...	0.44	0.49	0.48	0.54	17.39 <sup>a</sup>
Spain	...	...	...	...	...	...	...
Sweden	0.39	0.40	0.41	0.44	0.45	0.43	7.50
United Kingdom	0.36	0.44	0.46	0.48	0.48	0.46	4.55
United States	0.37	0.40	0.42	0.45	0.45	0.46	15.00

*Gini coefficient after taxes*

Country	mid-1970s	mid-1980s	around 1990	mid-1990s	around 2000	mid-2000s	Change from mid-1980s to mid-2000s (%)
Austria	...	0.24	...	0.24	0.25	0.27	12.50
Belgium	...	0.27	...	0.29	0.29	0.27	0.00
France	...	0.31	0.30	0.28	0.28	0.28	<b>-9.68</b>
Germany	...	0.26	0.26	0.27	0.27	0.30	15.38
Greece	0.41	0.34	...	0.34	0.34	0.32	<b>-5.88</b>
Ireland	...	0.33	...	0.32	0.30	0.33	0.00
Italy	...	0.31	0.30	0.35	0.34	0.35	12.90
Japan	...	0.30	...	0.32	0.34	0.32	6.67
Netherlands	0.25	0.26	0.28	0.28	0.28	0.27	3.85
Portugal	0.35	...	0.33	0.36	0.36	0.38	8.57 <sup>a</sup>
Spain	...	0.37	0.34	0.34	0.34	0.32	<b>-13.51</b>
Sweden	0.21	0.20	0.21	0.21	0.24	0.23	15.00
United Kingdom	0.28	0.33	0.37	0.35	0.37	0.34	3.03
United States	0.32	0.34	0.35	0.36	0.36	0.38	11.76

Note: Data refer to cash income of households and are broken down to individuals. The income attributed to each individual is adjusted for household size, but does not distinguish between adults and children. Figures in bold mean a decrease in inequality from the mid-1980s to the mid-2000s.

<sup>a</sup> Change from mid-1970s to mid-2000s.

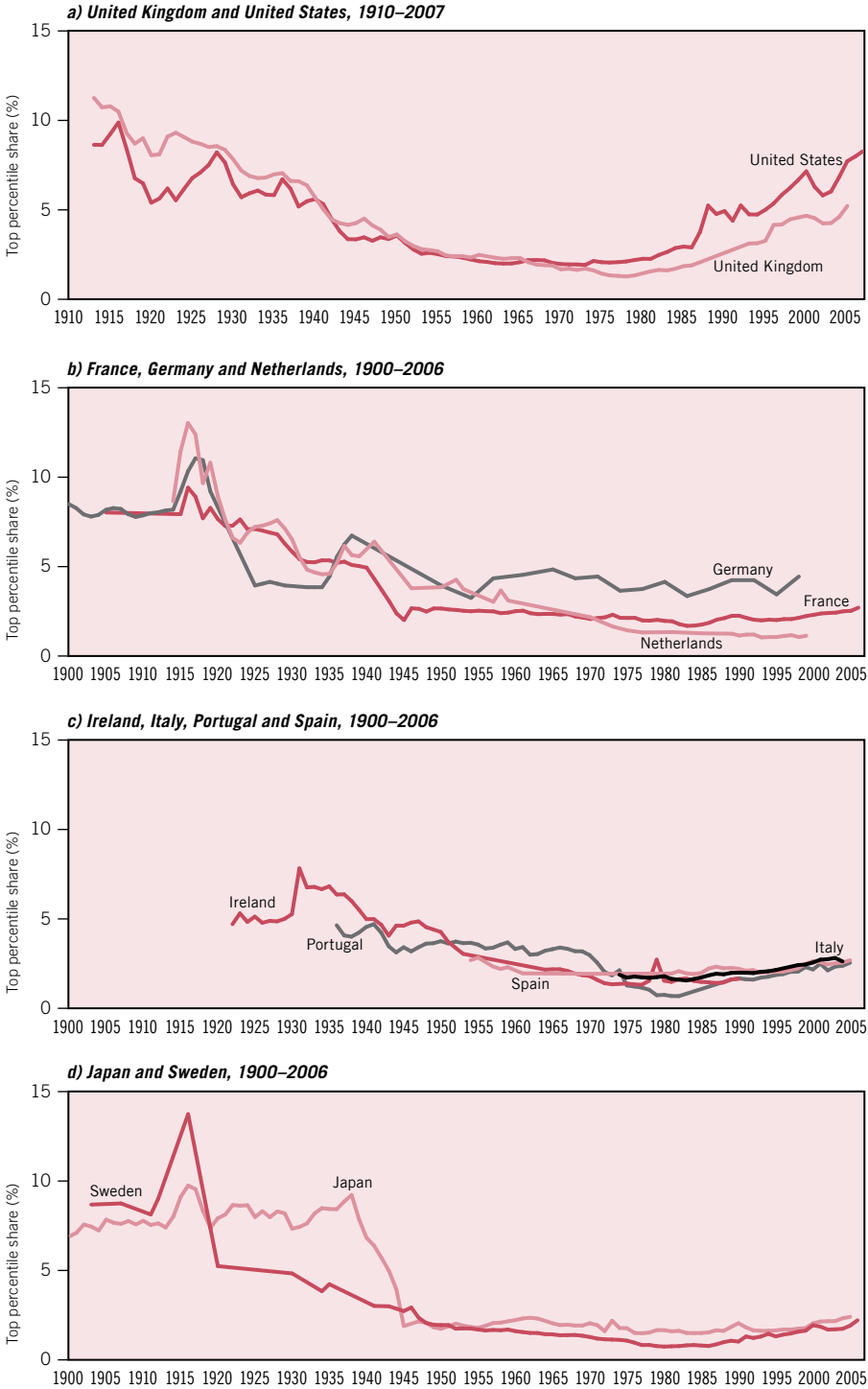
Source: OECD (2010), author's calculations.

surpassed by its counterparts in the United States and the United Kingdom only since the late 1980s and the mid-1990s, respectively.

The increase in the income share of the top 0.1 per cent in the United States has been driven mainly by an increase in business income (profits from sole proprietorship, partnerships, and so on) and by the increase in top earnings, including wages and salaries, bonuses, exercised stock-options and pensions, whereas the share of capital income (interest, dividends, rents, royalties



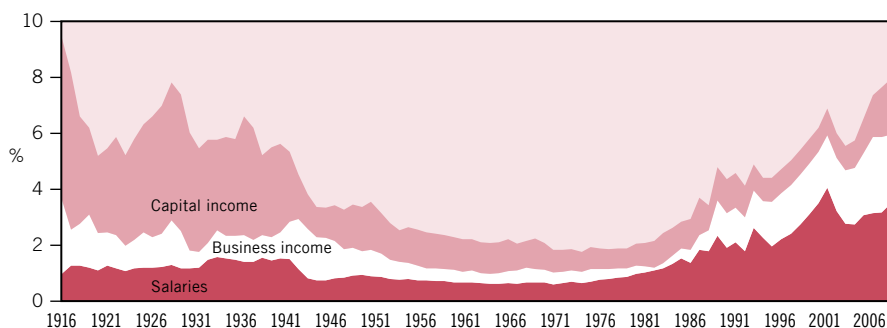
**Figure 1. Top 0.1 per cent share in national income**



Source: Atkinson, Piketty and Saez (2011).

and the like) in the top 0.1 per cent income share has remained roughly constant (figure 2). The earnings of top management (“the working rich”) have therefore contributed significantly, but not exclusively, to rising inequality in the United States from the early 1980s up to 2006. Similar trends can be observed for some other countries for which data are available (Atkinson, Piketty and Saez, 2011; Bach, Corneo and Steiner, 2009).

**Figure 2. The top 0.1 income share and its composition, United States, 1916–2007**



Notes: Income is defined as market income excluding capital gains (excludes all government transfers). Salaries include wages and salaries, bonuses, exercised stock-options, and pensions. Business income includes profits from sole proprietorships, partnerships, etc. Capital income includes interest income, dividends, rents, royalties, and fiduciary income.

Source: Atkinson, Piketty and Saez (2011).

Since top management earnings are included as compensation of employees in the national accounts and therefore are included in the wage share considered above, the increase in top management earnings in the period of neo-liberalism and financialization has mitigated the drop in the measured wage share since the early 1980s. To exclude top management earnings from the wage share would therefore result in an even more pronounced fall in the share of “ordinary labour”.<sup>5</sup>

### Redistribution, global and regional imbalances

Against the backdrop of rising inequality in personal income distribution and falling labour income shares associated with financialization and neo-liberalism since the early 1980s, two “models of capitalism under financialization”

5. See Buchele and Christiansen (2007) for such an exercise for the US corporate sector. They somewhat arbitrarily identify the share of the top 0.5 per cent of wage and salary income as payments to corporate officers on the basis of their “proximity to capital” and exclude these earnings from the wage share. See also Glyn (2009) for a similar approach for the United States, and Atkinson (2009) for the United Kingdom.

have developed.<sup>6</sup> They are complementary and have fed rising current account imbalances in the world economy, but also at regional levels, particularly in the euro area.<sup>7</sup> On the one hand, we have the “debt-led consumption boom” model; on the other, the “export-led mercantilist” model has developed as a counterpart at the global (and also at the euro area) level. In the former model, debt-financed consumption demand allows for aggregate demand to flourish and for rising profits to be made on the basis of redistribution at the expense of (low) labour incomes and stagnating real investment. In the latter model, export surpluses stabilize aggregate demand and account for profit-making.<sup>8</sup> Since the global and intra-EMU (European Monetary Union) current account imbalances have exploded, notably since the early 2000s (figures 3a and 3b) in the course of recovery from the bust of the new economy boom of the late 1990s, we take cyclical average data for the trade cycle of the early 2000s to distinguish these models and to assign to them the countries examined in this paper accordingly.<sup>9</sup>

In the cycle of the early 2000s, the “debt-led consumption boom” model can be observed in Greece, Ireland, Spain, the United Kingdom and the United States (table 3a). All these economies have seen considerable increases in residential property prices and/or in wealth-income ratios in the period considered here (Hein, 2010a). This increase in notional wealth, combined with liberalized financial markets and relaxed criteria in evaluating creditworthiness, was conducive to soaring consumption demand, and hence considerable growth contributions of private consumption and domestic demand. The resulting consequences included relatively high real GDP growth as compared to the “export-led mercantilist” countries, but also increasing household debt and hence negative financial balances (as a share of nominal GDP) of the private household sector. With the exception of the United Kingdom, this also translated into negative balances of the private sector as a whole – with the corporate sector being in surplus in all countries

6. For a similar analysis, see van Treeck, Hein and Dünhaupt (2007); Bibow (2008); Fitoussi and Stiglitz (2009); Horn et al. (2009); Sapir (2009); UNCTAD (2009); van Treeck (2009); Wade (2009); Hein and Truger (2010, 2011); Stockhammer (2010a, 2010b).

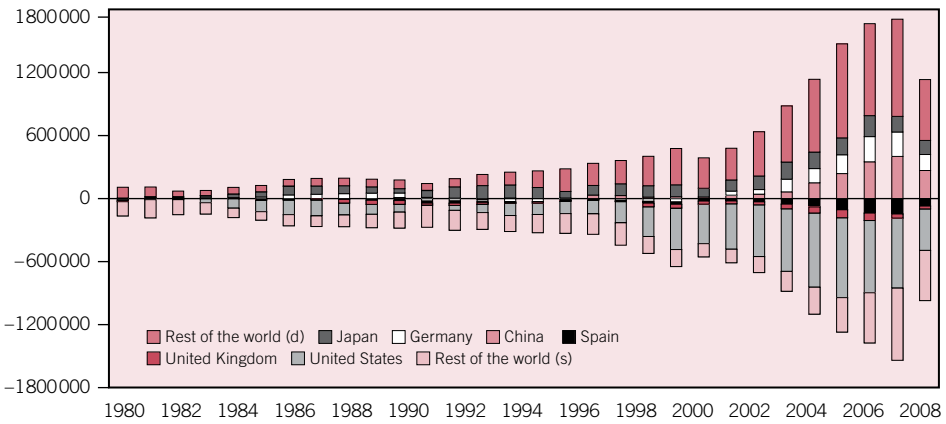
7. The current account of the euro area has been roughly balanced on average over the cycle from the early 2000s to 2008 (European Commission, 2010), so that in the aggregate current account surplus member countries have their respective deficit counterparts within the euro area. Of course, individual euro Member States also have surpluses or deficits vis-à-vis the non-euro area rest of the world. But these roughly cancel out for the euro area in the aggregate.

8. Note that from national accounting we obtain: Gross profits net of taxes = Gross investment + Export surplus + Government budget deficit – Worker’s savings + Capitalists’ consumption (Kalecki, 1971, p. 82).

9. As will be seen below, France, Italy and Portugal did not follow either of these two models.

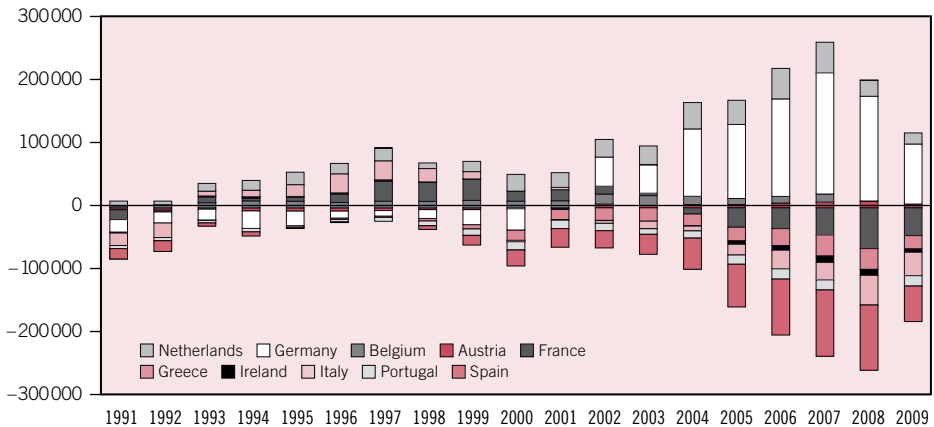
of this group except in Spain. The public sector contributed to the negative domestic financial balance in all the countries, but in varying degrees – considerably in Greece, the United Kingdom and the United States, but only marginally in Ireland and Spain. Since aggregate domestic expenditures exceeded national income, these countries had to run current account deficits, i.e. the financial balances of the external sector (as a share of nominal GDP) were positive for each of the countries pursuing the “debt-led consumption boom” model. In particular, Greece, Spain and the United States had to rely on the inflow of foreign financial resources. Strong domestic demand growth in the “debt-led consumption boom countries” translated into negative growth contributions of the balance of goods and services in all of these countries but Ireland, where the growth contribution of external demand

**Figure 3a. Current account balances, 1980–2008, US\$ (millions)**



Source: IMF (2010), author's calculations.

**Figure 3b. Current account, selected euro area countries, 1991–2009, ECU/euro (millions)**



Source: European Commission (2010), author's calculations.

was positive.<sup>10</sup> For the euro area countries in this group, above-average unit labour cost growth and inflation accompanied by nominal appreciation of the euro, and thus a loss of competitiveness for domestic producers (positive rates of change in the effective exchange rate) contributed to the deficits in the balance of goods and services and in the current account. However, the United Kingdom and the United States managed to improve competi-

**Table 3a. Key macroeconomic variables for “debt-led consumption boom” economies, average values for the trade cycle, early 2000s–2008 (percentages)**

	Greece	Ireland	Spain	United Kingdom	United States
Financial balances of external sector as a share of nominal GDP	12.49	2.88	7.10	2.22	5.00
Financial balances of public sector as share of nominal GDP	-5.74	-0.13	-0.03	-3.25	-3.51
Financial balance of private sector as a share of nominal GDP	-6.75	-2.74	-7.07	1.03	-1.49
Financial balance of private household sector as a share of nominal GDP	-11.44	-6.29	-1.54	-2.70	-1.83
Financial balance of corporate sector as a share of nominal GDP	4.69	3.55	-5.53	3.73	0.34
Real GDP growth	3.89	3.92	3.02	2.28	2.16
Growth contribution of domestic demand including stocks	4.10	3.26	3.82	2.53	2.22
Growth contribution of private consumption	2.79	1.87	1.74	1.52	1.76
Growth contribution of public consumption	0.49	0.59	0.93	0.49	0.37
Growth contribution of gross fixed capital formation	0.79	0.79	1.14	0.54	0.14
Growth contribution of the balance of goods and services	-0.20	0.66	-0.81	-0.24	-0.06
Net exports of goods and services as a share of nominal GDP	-10.97	12.23	-4.69	-2.86	-4.87
Change in labour income, share as percentage of GDP at current factor costs, from previous cycle	-1.40	-5.17	-3.71	-1.32	-1.32
Growth rate of nominal unit labour costs	3.47	3.95	3.31	2.40	1.93
Inflation (HCPI growth rate)	3.41	3.50	3.33	2.04	2.83
Growth rate of nominal effective exchange rates (relative to 23 countries)	1.60	2.81	1.53	-1.33	-2.84
Growth rate of real effective exchange rates (relative to 23 countries)	2.91	4.97	2.82	-0.75	-2.99

Note: The beginning of a trade cycle is given by a local minimum of annual real GDP growth in the respective country.

Source: European Commission (2010), author's calculations.

tiveness in the course of the cycle of the 2000s, but their current accounts deteriorated further compared to the previous cycle – that is, the financial balances of the external sector increased respectively. Thus, the “debt-led consumption boom” economies were the world demand engines of the cycle from the early 2000s to 2008.

10. In the case of Ireland, the current account deficit (and the positive financial balance of the external sector) was not due to a deficit in external trade but rather to a deficit in primary income flows. Although its balance of goods and services was positive, we have not included Ireland in the “export-led mercantilist” group of countries discussed below because, like the other “debt-led consumption boom” countries, it showed a negative balance of the private sector and of the domestic sectors as a whole. Surpluses in the balance of goods and services were thus required to meet the payment commitments associated with the negative balance of primary incomes and to avoid an even larger deficit in the current account.

The counterparts to the “debt-led consumption boom” economies at the world and euro area levels were the “export-led mercantilist” economies. This group comprises Austria, Belgium, China, Germany, Japan, the Netherlands and Sweden (table 3b). Surpluses in the balances of goods and services and in the current accounts were a common feature of these economies – that is, the financial balances of the respective external sectors were in deficit. Although some of these countries (Belgium, the Netherlands, Sweden) had seen considerable increases in wealth–income ratios and/or in residential property prices, whereas others had not (Austria, China, Germany, Japan) (Hein, 2010a), the financial balances of private households (as a share of nominal GDP) remained in surplus. The financial balances of the private sectors (as a share of nominal GDP) were strongly positive in each of the countries. Growth contributions of private consumption and domestic demand were either moderate, as in Austria, Belgium, the Netherlands and Sweden, or very weak, as in Germany and Japan. These countries relied considerably on positive growth contributions of the balance of goods and services. Only in Belgium was the growth contribution of external demand rather small. The basis for external surpluses was thus weak domestic demand on the one hand, and also low unit labour cost growth, low inflation and, in the case of Japan, nominal depreciation of the currency on the other. For “export-led mercantilist” euro area countries the real effective exchange rate relative to 23 industrial economies increased to a lesser extent than in the “debt-led consumption boom” euro area countries, implying an increase in price competitiveness of the former relative to the latter. Japan and Sweden managed to increase price competitiveness absolutely. The “export-led mercantilist” countries thus benefited from a world demand driven by the “debt-led consumption boom” countries. However, adherence to this model came at a price: with the exception of Sweden, and notably China’s catching up, GDP growth in the export-led countries remained well below GDP growth in the debt-led economies, and in particular the more closed large economies of Germany and Japan performed even worse than the more open and smaller economies of Austria, Belgium and the Netherlands.

Against the background of financialization and income redistribution at the expense of lower-wage incomes and the labour income share, a highly fragile constellation had developed at national, regional (euro area) and global levels in the course of the trade cycle of the early 2000s.<sup>11</sup> The dynamic “debt-led consumption boom” model of the United States and the other countries using this model were obliged to rely on the willingness and the ability of private households to increase debt–income ratios, and thus on ever-rising national wealth, in particular rising residential property prices, (seemingly) providing collateral for credit and/or progressively more lax

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11. For similar arguments see also Fitoussi and Stiglitz (2009); Hein and Truger (2010, 2011); Horn et al. (2009); Stockhammer (2010a).

**Table 3b. Key macroeconomic variables for “export-led mercantilist” economies, average values for the trade cycle, early 2000s–2008 (percentages)**

	Austria	Belgium	Germany	Netherlands	Sweden	Japan	China
Financial balances of external sector as a share of nominal GDP	-2.26	-3.90	-5.55	-7.15	-7.14	-3.45	-5.40
Financial balances of public sector as a share of nominal GDP	-1.45	-0.56	-2.09	-0.85	1.30	-5.16	-1.61
Financial balance of private sector as a share of nominal GDP	3.70	4.46	7.64	8.00	5.84	8.61	7.01
Financial balance of private household sector as a share of nominal GDP	4.68	4.25	5.90	0.16	3.86	3.65	...
Financial balance of corporate sector as a share of nominal GDP	-0.98	0.21	1.74	7.84	1.98	4.96	...
Real GDP growth	2.13	1.84	1.44	1.96	2.42	1.22	10.42
Growth contribution of domestic demand including stocks	1.26	1.70	0.85	1.43	1.85	0.75	...
Growth contribution of private consumption	0.76	0.63	0.18	0.37	0.94	0.61	...
Growth contribution of public consumption	0.28	0.45	0.16	0.75	0.24	0.29	...
Growth contribution of gross fixed capital formation	0.19	0.62	0.49	0.35	0.71	-0.16	...
Growth contribution of the balance of goods and services	0.77	0.14	0.58	0.52	0.57	0.46	...
Net exports of goods and services as a share of nominal GDP	4.35	4.02	5.56	7.63	7.45	1.24	4.72
Change in labour income, share as percentage of GDP at current factor costs, from previous cycle	-5.54	-1.58	-2.71	-1.64	2.13	-4.73	...
Growth rate of nominal unit labour costs	1.05	2.02	0.17	1.88	1.61	-2.12	...
Inflation (HCPI growth rate), per cent	2.12	2.34	1.78	1.94	1.80	-0.06	2.15
Growth rate of nominal effective exchange rates (relative to 23 countries)	1.21	1.48	2.09	1.37	0.26	-1.92	...
Growth rate of real effective exchange rates (relative to 23 countries)	0.55	1.58	0.14	1.56	-0.28	-6.00	...

Note: The beginning of a trade cycle is given by a local minimum of annual real GDP growth in the respective country.

\* China: consumer price inflation.

Source: European Commission (2010) for all countries except China; IMF (2010) for China; author's calculations.

Redistribution,  
global imbalances  
and the financial  
and economic  
crisis

creditworthiness standards, with the associated increase in financial fragility. They also had to rely on the willingness of the rest of the world – notably the “export-led mercantilist” countries – to run current account surpluses and thus to supply credit in order to finance the related current account deficits in the “debt-led consumption boom” economies. Conversely, the slow-growing or stagnating “export-led mercantilist” economies had to rely on the willingness and the ability of the rest of the world – notably the “debt-led consumption boom” economies – to go into debt, because their moderate or weak growth rates were dependent on dynamic growth of world demand and their export markets.

The collapse of a “debt-led consumption boom”, as triggered by the collapse of the subprime mortgage market in the United States in 2007, therefore not only affected the “debt-led consumption boom” economies but also had repercussions for the “export-led mercantilist” economies. On the one hand, their export markets collapsed in the crisis and they faced serious aggregate demand problems. On the other hand, they were infected via the financial markets because their capital exports might be drastically devalued if they were directed towards the risky and now collapsing financial markets of the “debt-led consumption boom” economies. Both transmission channels were activated during the present crisis. In 2009, GDP growth in the stagnating “export-led mercantilist” economies of Germany (–5.0 per cent) and Japan (–5.2 per cent) was hit even harder than growth in the main “debt-led consumption boom” economy of the United States (–2.4 per cent), where the crisis originated (European Commission, 2010).<sup>12</sup> But neither have the “debt-led consumption boom” economies been hit by the crisis equally. Whereas the United States, able to issue debt in its own currency, suffered “only” from the financial and economic crisis, in other countries, notably Greece, the crisis also became a public debt crisis and contributed to a currency crisis – the euro crisis of 2010.<sup>13</sup>

### **An income-led recovery strategy embedded in a “Keynesian New Deal”**

We have seen how redistribution at the expense of low-wage incomes and the labour income share, associated with neo-liberalism and financialization, has contributed to macroeconomic instability at the national, European and global levels, and thus exacerbated the recent crisis. From our analysis it follows that a medium- to long-term sustainable recovery strategy for major areas of the developed world economy can apply neither the “debt-led

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12. See Hein and Truger (2010) for a case study on Germany in the international context.

13. See Hein and Truger (forthcoming) for a more detailed analysis of the underlying imbalances of the euro crisis of 2010.



consumption boom” model nor the “export-led mercantilist” model.<sup>14</sup> Over-indebtedness of private households must be avoided, as must persistent current account surpluses or deficits which are not due to productivity growth catch-up processes of less-developed economies.<sup>15</sup> Hence, any medium- to long-term recovery strategy must be income- or wage-led only. This means that wages will have to rise broadly in line with (potential) output. Labour income shares must therefore be at least roughly stable in the medium to long term. They may even rise should distribution claims of firms, rentiers, the state or the foreign sector fall, for instance when price competitiveness in the goods market increases, or interest rates, dividend rates, tax rates or import prices drop, thus permitting a rise of the labour income share without triggering cumulative inflationary processes. In this case, the economy may also benefit from wage-push effects on the growth of productivity, where a rise in real wages and labour income shares influences firms to speed up the introduction of labour-saving innovation into the production process and thus increases potential growth.<sup>16</sup> A wage-led recovery strategy would therefore also contribute to overcoming the tendencies towards the sluggish growth of productivity associated with financialization and neo-liberalism (Hein, forthcoming). These tendencies have been imposed through the long-term depressing impact of financialization and neo-liberalism on the labour income share, thus dampening the wage-push effect on capital accumulation, with a negative effect on capital-embodied technical progress and thus productivity growth, as well as on aggregate demand growth, thereby dampening the “Verdoorn” effect on productivity growth.<sup>17</sup>

A wage-led recovery strategy requires addressing the three main causes for the fall in the labour income share in the period of neo-liberalism and financialization: first, the bargaining power of trade unions has to be stabilized and enhanced; second, overhead costs of firms must be reduced, in particular top management earnings and interest payments, as well as profit claims of financial wealth-holders; and third, the sectoral composition of the economy has to be shifted away from the high-profit-share financial corporations towards the non-financial corporate sector and the public sector.

While reversing the trends in primary functional distribution is the key to any wage-led recovery strategy, distribution or incomes policies should

14. For a critique of export-led strategies see also UNCTAD (2010, pp. 77–97).

15. Since deficits or surpluses in the balance of goods and services are mainly affected by growth differentials, it may be too restrictive to require balanced current accounts from developing countries in a productivity catch-up process. However, the risks of indebtedness in foreign currency with persistent deficits in the current accounts have to be considered as well. Here is not the place to elaborate on this issue.

16. For empirical results see Hein and Tarassow (2010); Marquetti (2004); Naastepad (2006); Vergeer and Kleinknecht (2007).

17. The “Verdoorn” effect denotes the positive relationship between demand growth and productivity growth.

address more than primary functional distribution alone. They should also directly focus on reducing inequality of personal distribution of income, in particular of disposable income. This means that the tendencies towards increasing wage dispersion need to be contained and, in particular, that progressive tax policies and social policies be applied to reduce inequality in the distribution of disposable income.

Distribution or incomes policies are therefore at the core of, and should be embedded in, a “Keynesian New Deal”, which in broader terms will have to address the three main causes responsible for the severity of the crisis: inefficient regulation of financial markets, increasing inequality in the distribution of income and rising imbalances at the global (and euro area) level. We have developed (Hein and Truger, forthcoming) three main pillars to support a policy package of a “Keynesian New Deal at the global and European levels”: first, re-regulation of the financial sector in order to prevent future financial excesses and financial crises; second, reorientation of macroeconomic policies with an eye to domestic demand, in particular in current account surplus countries; and third, re-construction of international macroeconomic policy coordination – in particular at the European level – and a new world financial order. The main building blocks of such a Keynesian New Deal are identified hereunder, and highlight the role of distribution and incomes policies.

The re-regulation of the financial system requires introduction of a host of measures which should aim to orient the financial sector towards financing *real* economic activity, namely real investment and real GDP growth.<sup>18</sup> This involves at least three dimensions. First is the introduction of measures to increase transparency in financial markets in order to reduce the problems of uncertainty, asymmetric information, moral hazard and fraud which are inherent to this sector in particular. These measures include the standardization and supervision of all financial products in order to increase transparency in the market. Off-balance-sheet operations should be abolished. National and international regulation and supervision of all financial intermediaries (banks, insurances, hedge funds, private equity funds, and so on) should be introduced. Since rating can be considered a public good, independent public rating agencies will have to be introduced to replace the private ones. The banking sector should be diversified more to increase resilience. Public and cooperative banks supplying credit to households and small firms, thus competing with private banks, should be strengthened. Financial institutions with systemic relevance should be publicly owned, as stability of these institutions can be considered to be a public good, too. Second, improved regulatory measure should generate incentives encouraging economic actors in the financial and non-financial sectors to focus on long-term growth

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18. For detailed lists of required regulation see, for example, Ash et al. (2009); Fitoussi and Stiglitz (2009); Wade (2009).

rather than on short-term profits. This includes reduced securitization in order to prevent “originate and distribute” strategies which were at the root of the US subprime mortgage crisis. Banks should be induced to do what banks are supposed to do – that is, evaluate potential creditors and their investment projects, grant credit and supervise the fulfilment of payment commitments by the debtor. For the financial and non-financial corporate sector, share buy-backs with intent to drive share prices upward should be reduced or even abolished. Short-term attitudes of managers in the corporate sector should be minimized by means of reducing stock option programmes and by extending minimum holding periods. Generally, codetermination at the corporate level and improved rights of other stakeholders in the firm should be strengthened to put an end to the short-term approach and to scale up the importance of investment in long-term projects aiming to improve productivity and the development of new products. Third, measures should be implemented to contain systemic instability, such as asset-based reserve requirements and countercyclical capital requirements for all financial intermediaries. A general financial transactions tax should also be implemented for this purpose.

Apart from stabilizing and directing the financial sector towards financing real economic activity, these measures should affect distribution and thus positively feed back into aggregate demand and growth through the following channels: first, since these measures imply a downsized financial sector they will contribute to an increasing labour income share through the change in the sectoral composition of the economy. Second, reducing top management earnings and profit claims by financial wealth-holders will allow for lower mark-ups in price-setting by firms and thus higher labour income shares. Third, refocusing managerial orientation towards long-run corporate expansion will increase the bargaining power of both workers and trade unions, and will therefore have a dampening effect on profit claims.

The reorientation of macroeconomic policies – in particular in current account surplus countries – should aim to improve domestic demand, employment and hence also imports into these countries. We propose a blueprint for a post-Keynesian macroeconomic policy mix (Hein and Stockhammer, 2010), which could serve as a guide for this reorientation – as opposed to the New Consensus model focusing on labour market deregulation to reduce the Non Accelerating Inflation Rate of Unemployment (NAIRU) and on monetary policy for short-term real and long-term nominal stabilization.<sup>19</sup>

First, central bank interest rate policies should abstain from attempting to fine-tune unemployment in the short run and inflation in the long run, as suggested by the New Consensus approach. Central banks should instead target low real interest rates to avoid unfavourable cost and distribution effects on firms and workers, while favouring rentiers. A slightly positive

19. For the New Consensus model see, for example, Goodfriend and King (1997); Clarida, Gali and Gertler (1999).

real rate of interest, below the rate of productivity growth, seems to be a reasonable target: the real financial wealth of rentiers will be protected against inflation but overhead costs for firms will be reduced, allowing for a shift of income distribution in favour of labour with stimulating effects on aggregate demand. Further on, central banks must act as a lender of last resort in periods of liquidity crisis, and they should be involved in the regulation and supervision of financial markets.

Second, fiscal policies should be responsible for real stabilization, full employment and a more equal distribution of disposable income. Progressive income tax policies, relevant wealth, property and inheritance taxes, and redistributive social policies would improve conditions in favour of an income-led recovery. If required by surpluses in private-sector financial balances, medium- to long-term government deficits should maintain aggregate demand at high levels, thus allowing for high employment.<sup>20</sup> In particular, in current account surplus countries with private-sector financial surpluses, governments will have to run budget deficits to stabilize aggregate demand at the national level on the one hand, and to contribute to rebalancing the current accounts at the international level, on the other. Fiscal policies will therefore have a major role to play in rebalancing current accounts at the global and the regional (euro area) levels. Unfavourable regressive distribution effects of public debt can be avoided by central bank policies targeting low interest rates and/or by appropriate taxation of capital income. Short-term aggregate demand shocks should be countered by automatic stabilizers and by discretionary countercyclical fiscal policies.

Third, incomes and wage policies should take over responsibility for nominal stabilization, that is, stabilizing inflation at some target rate which contributes to maintaining a balanced current account. If distribution claims of firms, rentiers, government and the external sector are constant, nominal wages should rise according to the sum of long-term economy-wide growth of labour productivity plus the inflation target. A reduction in claims by the other actors, however, would allow for an increase of nominal wages exceeding this benchmark. In order to contribute to rebalancing the current accounts, nominal wage growth in the current account surplus countries will have to exceed the benchmark for an interim period, whereas nominal wage growth in the deficit countries will have to fall short of the benchmark during the adjustment process. In order to achieve the nominal wage growth targets, a high degree of wage bargaining coordination at the macroeconomic level, and organized labour markets with strong labour unions and employer associations, seem to be a necessary condition. Legal minimum wage legislation should contain wage dispersion and thus contribute to a more equal distribution of income.

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20. On the “functional finance” view proposed here, see Lerner (1943); Kalecki (1944); Arestis and Sawyer (2004).

On the international level, policy coordination must ensure that “export-led mercantilist” strategies and the associated pressure on labour unions to moderate wage claims in favour of increasing international competitiveness are no longer viable. This implies that targets for current account balances have to be included in international policy coordination at the regional and global levels. A reform of economic policy institutions in the European Union and the euro area tackling the present imbalances implies that the framework for the European Central Bank (ECB) has to be changed in such a way that the ECB will have to pursue long-term policies targeting low interest rates, and that the orientation of labour market and social policies towards deregulation and greater flexibility will have to be abandoned in favour of reorganizing labour markets, stabilizing labour unions and employer associations, along with euro area-wide minimum wage legislation.<sup>21</sup> A change in European policy institutions means, in particular, that the Stability and Growth Pact (SGP) at the European level has to be abandoned and needs to be replaced by a means of coordination of national fiscal policies at the Euro area level which allows for the short- and long-run stabilising role of fiscal policies incorporating current account targets. At the global level, the return to a cooperative world financial order and a system with fixed but adjustable exchange rates, symmetric adjustment obligations for current account deficit and surplus countries, and regulated international capital flows seems to be required to avoid the imbalances that have contributed to the present crisis and to preclude “export-led mercantilist” policies by major economies. The Keynes (1942) proposal for an International Clearing Union is the obvious blueprint for this.<sup>22</sup>

## Summary and conclusions

We have argued here that the severity of the present crisis cannot be understood without examining the medium- to long-term developments in the world economy since the early 1980s: inefficient regulation of financial markets, increasing inequality in income distribution, and rising imbalances at the global level as well as in the euro area. Our focus has been on the changes in distribution in effect triggered by finance-dominated capitalism embedded in a neo-liberal policy stance since the early 1980s, on the global and regional imbalances underlying the present financial and economic crisis, and on the requirements for distribution policies in an expansionary post-crisis economic policy regime.

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21. For a more detailed discussion of required economic policy reforms in the European Union and the euro area, see Hein and Truger (forthcoming).

22. See also Davidson (2009, pp. 134–142); Guttman (2009); Kregel (2009); UNCTAD (2009); Wade (2009).

In examining the three dimensions of redistribution in the course of financialization and neo-liberalism since the early 1980s – functional distribution, personal distribution and the development of top incomes – we have shown that this period was marked by a falling labour income share and by increasing inequality in the distribution of personal disposable income. The United Kingdom and the United States have also seen a dramatic increase in the income shares of top management, whereas in the other countries this increase has been only modest.

The following section reported the escalating regional (euro area) and global current account imbalances in the early 2000s to be among the sources which contributed to the severity of the crisis originating in 2007. We have shown that during the trade cycle of the early 2000s two “models of capitalism under financialization” developed, the “debt-led consumption boom” and the “export-led mercantilist” model. Since the former model, generating higher rates of growth than the latter – with the exception of China – has incurred current account deficits, these two models are considered complementary in having generated a highly fragile constellation. The collapse of the “debt-led consumption boom” therefore quickly impacted the “export-led mercantilist” economies through the collapse of their export markets and through devaluation of their capital exports in risky financial markets in the course of the financial crisis.

Finally, we have drawn the economic policy conclusions from our analysis. We have argued that no sustainable recovery strategy to emerge from the crisis can follow either the “debt-led consumption boom” or the “export-led mercantilist” model, but must necessarily be income- or wage-led. A wage-led recovery strategy will need to address the main causes for the falling labour income share in the period of neo-liberalism and financialization: first, the bargaining power of trade unions must be stabilized and enhanced; second, overhead costs of firms, in particular top management earnings and interest payments, and profit claims of financial wealth-holders, have to be reduced; and third, the sectoral composition of the economy must be shifted away from the high-profit-share financial corporations towards the non-financial corporate sector and the public sector. Furthermore, the tendencies towards increasing wage dispersion need to be contained and, in particular, progressive tax policies and social policies need to be applied in the interest of reducing inequality in the distribution of disposable income. We have claimed that a wage-led recovery strategy is at the core of and should be embedded in a “Keynesian New Deal” which, more broadly, will call for the three main causes for the severity of the crisis to be addressed. This strategy would rest on three pillars: first, the re-regulation of the financial sector to prevent future financial excesses and financial crises; second, the re-orientation of macroeconomic policies towards stimulation of domestic demand, in particular in the current account surplus countries; and third, the re-construction of international macroeconomic policy coordination – in particular at the European level – and a new world financial order.

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# Macroeconomic policy for “full and productive employment and decent work for all”: An overview

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## Introduction

The Millennium Development Goals (MDGs), launched after the UN Millennium Summit of September 2000, represented a renewed commitment by the international community to global poverty reduction. At the time the MDGs were unveiled, there was no reference to the attainment of “full and productive employment and decent work for all” as a vehicle for sustainable reductions in global poverty. This omission occurred despite the fact that the World Summit on Social Development which led to the Copenhagen Declaration of 1995 included full employment as a basic policy goal and was an integral part of its “ten commitments”.<sup>1</sup> It took several years before “full and productive employment and decent work for all” became a key target (target 1B) under the first MDG of eradicating extreme poverty and hunger.<sup>2</sup>

The reinstatement of one of the ten commitments of the Copenhagen Declaration represents a most welcome change after decades in which orthodox macroeconomics held sway and the notion of full employment became marginalized in the operational guidelines of central banks and finance ministries across the world. Indeed, MDG target 1B, along with ILO Convention No. 122, which “aims to stimulate economic growth based on full, productive and freely chosen employment”, can serve as a beacon to guide the current quest for an appropriate post-crisis macroeconomic policy paradigm.<sup>3</sup> More importantly, this is the only universal target applicable to all countries and not exclusively to developing countries (it applies, say, to the United States as much as it does to Uganda).<sup>4</sup>

Rather than simply monitoring MDG target 1B, what challenges lie ahead in actively promoting it as a key consideration in the rethinking of macroeconomic policy for the post-crisis era? How can such challenges be overcome in a pragmatic policy agenda that can be adapted to country-specific circumstances? These are the issues explored in this paper. The purpose is to:

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1. See [http://www.un.org/esa/socdev/wssd/copenhagen\\_declaration.html](http://www.un.org/esa/socdev/wssd/copenhagen_declaration.html)

2. Even scholars who have assiduously sought to construct the evolution of the MDGs have paid insufficient attention to this anomaly (Hulme, 2009). The new MDG target on employment was launched in 2008 (ILO, 2009a). Hence, it took 13 years to make the transition from the 1995 Copenhagen Declaration to the 2008 version of the MDGs. Rodgers et al. (2009, p. 227) argue that the 2000 version of the MDGs was influenced by the OECD, the Bretton Woods institutions and the United Nations to “redefine the international agenda and narrow its focus”. For a critical look at the MDGs, see Chang (2010). See also Easterly (2006).

3. On ILO Convention No. 122 on employment policy and related recommendations, see ILO (2008, Chapter 7). So far, 100 countries (out of the 183 ILO member States) have ratified Convention No. 122, but the incidence of ratification is lowest in the Asia-Pacific region.

4. The indicators that are currently used to monitor target 1B apply to developing countries only, but they could be adapted to suit the particular circumstances of developed countries.

- offer a succinct guide to the current rethinking on macroeconomic policy;
- suggest some elements of a post-crisis macroeconomic paradigm more closely aligned with MDG target 1B.

### MDG target 1B as a guiding principle in the redesign of macroeconomic policy in the post-crisis era: Some challenges

There are significant challenges in the search for an appropriate post-crisis macroeconomic policy paradigm based on MDG target 1B. To start with, the UN officials who are investing their time and effort in developing indicators to monitor the MDGs have not spent enough time and effort to develop an intellectual roadmap towards the attainment of target 1B. To be fair, in the wake of the Great Recession, some attempts have been made by certain prominent advocates of the MDGs to rethink macroeconomic policy and to link it to long-term development concerns (see, for example, Sachs, 2009). Yet, it is equally fair to say that in the current global debates on macroeconomics for the post-crisis world, it is the work of Olivier Blanchard and his colleagues at the International Monetary Fund (IMF) that predominates. In their much-noted paper on rethinking macroeconomic policy, the emphasis is on incremental, but significant, adjustments rather than on a radical overhaul of the conventional framework (see Blanchard, Dell’Ariccia and Mauro, 2010).<sup>5</sup> This highlights the reality that, among international institutions, the IMF has the mandate and relevant expertise on global macroeconomic issues. Blanchard and his colleagues do not explicitly make the case for a renewed commitment to full employment as a core policy goal. This perpetuates the disconnect existing between recognized experts on macroeconomic policy and the advocacy of MDG target 1B by UN agencies as well as by the Bretton Woods institutions through their *Global Monitoring Report 2009*.

How can this divide be breached? Should we seek inspiration from the reflections of Sachs and call for a radical overhaul of the conventional policy framework that is primarily concerned with key macroeconomic aggregates? His call to link macroeconomic policy to long-term development concerns is certainly valid. On the other hand, the idea of a radical overhaul that moves the post-crisis macroeconomic policy agenda away from key macroeconomic aggregates pertaining to employment creation, price stability and fiscal sustainability renders such an agenda both amorphous and overly ambitious. Instead, we could steer a middle course that recognizes the significance of the

5. See also White (2009), who argues that “the prevailing paradigm of macroeconomics allows no room for crises”. Nobel laureate Paul Krugman (2009) blames leading US-based macroeconomists for their collective failure to forewarn the international community of the Great Recession.

intellectual changes taking place within the IMF and complement them by introducing the work of a range of scholars and institutions which have diligently sought to build an intellectually credible and pragmatic alternative to orthodox macroeconomics.

### **MDG target 1B as a guiding principle in the redesign of macroeconomic policy in the post-crisis era: Three guiding principles**

We can draw on the burgeoning literature to identify three guiding principles in constructing a post-crisis macroeconomic policy agenda allowing for progress towards the attainment of MDG target 1B. These guiding principles are set out in figure 1. First, it is necessary to change the norms and conventions of macroeconomic policy managers (central banks and finance ministries) by incorporating broader goals and more instruments. Second, it is necessary to improve the management of macroeconomic risks using a combination of prudential and protective tools. Third, it is necessary for low- and middle-income countries to have enhanced and equitable access to predictable sources of external financing that respond to both risk-management strategies and long-term development needs.

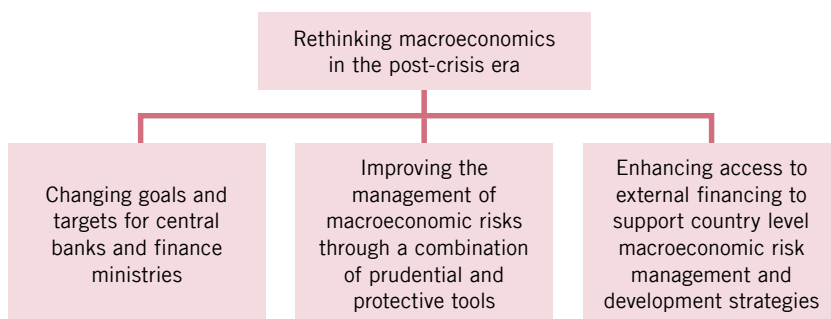
#### **Change the norms and conventions of macroeconomic policy managers at the national level by incorporating broader goals and multiple instruments**

Ever since New Zealand pioneered the implementation of an inflation targeting (IT) regime in 1990, central banks in a number of both developed and developing countries have adopted such a regime.<sup>6</sup> The focus is on attaining a predetermined inflation target over a given time period by using a single instrument, the policy interest rate. The median predetermined inflation target is 3 per cent for developed, developing and emerging economies that have adopted IT regimes. It is not clear how these targets were chosen, given that the median inflation rate for the 1980–2007 period for “high growth” developing and emerging economies was 7.6 per cent, while for others it ranged

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6. There are a total of 26 countries that might be classified as having inflation targeting (IT) regimes, of which 17 can be classified as developing and emerging economies using the IMF criterion. IT regimes can be pursued with or without central bank independence. See table A1 and figure A1 in Appendix. The rationale for IT regimes comes from the so-called “Taylor rule” (named after a seminal contribution by John Taylor in 1993) in which deviations of actual output from potential output (or “full employment” output) can be minimized if central bankers seek to attain an inflation target that is consistent with such a minimized output gap. For a critique and a clarification, see Cordero and Montecino (2010).

**Figure 1. Framework for rethinking macroeconomics in the post-crisis era**



from 8.6 to 15.7 per cent (see table A2 and figure A1 in Appendix). This aim for low, single-digit inflation disconnected from historical experience has probably led central bankers to be preoccupied with attaining very low inflation rates even at the expense of concerns about growth and employment. It is also well known that IT regimes pay “insufficient attention to the sources of inflation. If high inflation is a result of soaring energy and food prices, as was the case in 2006–07, a small country that raises its interest rates will do little to affect these global forces” (Stiglitz, 2010).<sup>7</sup> The latest findings on whether inflation targeting regimes yield better outcomes in terms of price stability and growth as well as reduced economic volatility are not encouraging (Brito and Bystedt, 2010).<sup>8</sup>

Another consequence of focusing on predetermined inflation targets is that its successful attainment requires avoidance of “fiscal dominance”, namely that “fiscal policy considerations cannot dictate monetary policy” (DeBelle et al., 1998). This view can be justified by appealing to the pitfalls and perils of macroeconomic populism which leads governments, especially in developing and emerging economies, to engage in fiscally profligate behaviour. Such governments are forced, in turn, to borrow from central banks. This will “create inflationary pressures of a fiscal origin [which] will undermine the effectiveness of monetary policy” in controlling inflation (ibid., p. 2). These considerations lie behind calls for tight fiscal rules aimed at limiting budget deficits to predetermined thresholds. Developing country

7. See Heinz and Ndikumuna (2010), who investigate the sources of inflationary pressure in sub-Saharan Africa using dynamic panel data. They conclude that formal inflation targeting needs to be amended so that the central bank can play a proactive role in the development process.

8. The authors conclude that there is no evidence that IT regimes improve either inflation or output growth in developing countries. IMF economist Scott Roger (2010) finds that “non-inflation targeting countries continued to have lower inflation and higher growth than inflation targeting countries”, but also observes that those that “adopted inflation targeting saw larger improvements in performance”.

governments that found themselves having to meet predetermined fiscal thresholds tried to do so by cutting capital expenditure while preserving current expenditure. One consequence was a secular decline in public investment in infrastructure (Roy and Heuty, 2009, Chapter 3).

The tendency to downplay the importance of fiscal policy in macroeconomic orthodoxy also stems from the so-called “Ricardian equivalence” and the “crowding out” thesis. The former maintains that public sector profligacy will be fully offset by private sector prudence. The latter argues that by raising the long-term real interest rate, increased public expenditure crowds out private investment opportunities. Thus, in both cases, fiscal policy cannot influence output and employment. Hence, in the orthodox framework it is possible to justify the reliance on monetary policy as the primary instrument for macroeconomic management.

Of course, the majority of both developed and developing countries have not adopted inflation targeting regimes and those that did practised inflation targeting in a flexible and pragmatic way. This caution is valid, but the dominant intellectual influence of “new classical macroeconomics” in developed countries remains, most notably after the emergence of world-wide stagflation in the post-oil shock 1970s.<sup>9</sup> This world view justified the stance on low inflation as an overarching goal by arguing that discretionary macroeconomic policy could not have lasting effects on employment which was primarily determined by market forces.

In the case of developing countries, the legacy left by the long period of “structural adjustment programmes” (SAPs) that lasted between 1980 and 1998 cannot be discounted.<sup>10</sup> The SAPs inevitably focused on low inflation and the appropriate configuration of monetary and fiscal policies that would attain this primary goal. Any reference to full employment was conspicuously absent.

The post-SAP period of the 2000s is widely characterized as the regime of poverty reduction strategies (PRSs) and poverty reduction strategy papers (PRSPs).<sup>11</sup> This appeared to be consistent with the renewed attention to the

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9. The irony is that there is a strand within the “new Keynesian” school that is, in many ways, sympathetic to the “new classical” view of the world. The former believes that wage/price rigidity is pervasive and hence, by implication, followers of this school accept that reducing such rigidities will bring the world closer to the new classical framework. See Stiglitz (2010, p. 258).

10. The SAPs represent the embodiment of the intellectual framework of global macroeconomic orthodoxy that was incorporated in the Washington Consensus. In the original version proposed by Williamson (1990), fiscal discipline is the first key prescription in a list of ten. See ILO (1987) for a critical appraisal of the SAPs. See also UN (2010) for a critique of SAPs and their impacts on poverty and inequality.

11. It would be useful to make a distinction between PRS and PRSP. The latter pertains to a specific product (a strategy paper), the former are a development strategy. Countries prefer to use the notion of PRS rather than PRSP. The PRSP approach was initiated by the Bretton Woods institutions in 1999. By June 2009, 90 PRSPs were finalized and more than 50 interim PRSPs were prepared. See IMF (2010).



alleviation of global poverty. Countries seeking financial assistance from the Bretton Woods institutions were required to produce PRSPs before such assistance could be offered. An internal evaluation by the ILO suggests that more recent PRSPs have reflected employment concerns. Yet, the introduction of the PRSPs also coincided with the adoption of inflation targeting regimes in the developing world. More importantly, an independent evaluation of IMF programmes in low-income countries claims that the macroeconomic framework that emerged from such programmes unduly constrained policy and fiscal space with respect to the health sector. For example, one of the conclusions is that “most recent IMF programs with low income countries have targeted inflation at very low levels (i.e., 5 per cent or lower)...Available empirical evidence does not justify pushing inflation down to these levels in low-income countries. The IMF should not be unduly risk-averse by ruling out more expansionary...fiscal options just because they may put upward pressure on prices” (Goldsbrough, 2007). Another study notes that “according to their Poverty Reduction Strategy Papers (PRSPs), fiscal policy in Malawi and Zambia focuses on keeping the overall balance at less than 1 per cent of GDP. The targets for inflation are set at less than 5 per cent. In Kenya, the inflation target for the period 2005–07 was 3.5 per cent” (Hailu, 2008).<sup>12</sup>

Olivier Blanchard and his colleagues at the IMF now note that the single-minded pursuit of low, single-digit inflation with a single policy instrument (the short-term interest rate), although necessary in taming the turbulent inflationary environment of the 1970s and 1980s, has probably outlived its usefulness. They have called for broader goals and more instruments, including the need to increase the predetermined inflation target so that monetary authorities have more room to move when faced with deflationary recessions. This is a welcome change in thinking because it complements the work of other scholars and institutions outside the IMF who have advocated the need to move away from an inflation targeting regime even before the advent of the Great Recession.

How might a new framework that emphasizes broader goals and multiple instruments for macroeconomic policy managers look? There are several directions in which these goals and instruments could evolve, ranging from the modest to the ambitious. These include:

- *Amend, rather than abandon, pre-determined inflation targets.* An obvious way to do so would be to raise the predetermined inflation target. Blanchard, Dell’Ariccia and Mauro (2010) suggest the possibility of raising the inflation target from 2 to 4 per cent. This is valid for developed countries, but not necessarily for developing and emerging economies. Empirical

12. Hailu argues that these targets were driven by concerns on the part of Bretton Woods institutions that a substantial scaling up of aid to finance the MDGs within the framework of the PRSPs might lead to “Dutch Disease” phenomenon that could impair macroeconomic stability.

and historical experience suggests that, as a rule, this could instead be set at 10 per cent or close to it.<sup>13</sup>

- *Extend the inflation targeting framework to take account of asset price inflation.* This is a direct consequence of the global recession of 2008–09 that was triggered by the bursting of the housing price bubble in the United States as of the mid-1990s. A number of commentators have argued that the monetary authorities ignored the formation of asset price bubbles even as they were successful in maintaining a low-inflation environment. Hence, monitoring asset price bubbles and dealing with them pre-emptively is now seen as a core task of central banks in reducing the probability of financial crises and thus avoiding the enormous losses in output and employment that they cause.
- *Take account of “supply-side” sources of inflation in designing monetary policy.* The role of “global forces” in influencing domestic inflation should be explicitly acknowledged. A classic case is the food and energy price shocks that badly hit developing countries in the late 2000s, just before the onset of the global recession. As is well known, the World Bank suggests that as a result of these price shocks, millions were pushed into transient episodes of poverty. The role that monetary policy can play in dealing with such shocks is strictly limited and central banks should refrain from using the policy interest rate to deal with such supply side forces. Government interventions to enhance food security represent much more appropriate responses.
- *Replace the inflation targeting framework with a focus on real exchange rate stability.* This point has been argued by a number of macroeconomists (Epstein and Yelden, 2009; Frankel, 2009; Frenkel and Rapetti, 2010) and by UNCTAD (2010). Such an approach moves away from the so-called “corner solutions” on exchange rate policy that became fashionable after the 1997 Asian financial crisis.<sup>14</sup> In the case of developing economies that have attained a significant degree of trade and financial integration, the

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13. A number of studies highlight a non-linear relationship between inflation and growth, implying that as inflation increases from a very low rate, this is associated with faster growth. See Khan and Senhadji (2001, pp. 1–21). Hence, the “10 per cent rule” could open the possibility of allowing somewhat higher inflation (than is currently prescribed) to support faster growth in developing economies. Some studies suggest that, in the case of many African countries, the very low inflation environment that prevailed in the 2000s was associated with actual output being below potential output (Njuguna and Karingi, 2007).

14. The advocates of “corner solutions” argue that developing countries should either go for fully floating or fully fixed exchange rates. Maintaining real exchange rate stability means active management of the nominal exchange rate either through rules or discretion. UNCTAD favours the use of “constant real exchange rate rules” (CRER) in which nominal rates are automatically adjusted on the basis of inflation differentials between a country and its major trading partners. UNCTAD recognizes that this will require global coordination among systemically important countries.

real exchange rate plays a key role in driving export growth, structural change and employment creation. Country-level experience suggests the implementation of inflation targeting can lead to painful trade-offs because the use of a single instrument (the policy interest rate) makes it difficult for monetary authorities to simultaneously meet the twin targets of low, single-digit inflation and real exchange rate stability (Epstein and Yelden, 2009; Frankel, 2009).

- *Replace the inflation targeting framework with an MDG-driven framework.* This is the key message of this concept note. Both monetary authorities and finance ministries in low- and middle-income countries can make a credible commitment to the attainment of MDG target 1B by incorporating it in their operating guidelines within a framework of price stability and fiscal sustainability.<sup>15</sup> In addition, governments can signal a commitment to full employment by ratifying ILO Convention No. 122, where such ratification has not yet taken place. One possible consequence of making a political commitment to full employment without forsaking macroeconomic prudence involves reducing incentives for central banks and finance ministries to be preoccupied with attaining low, single-digit inflation and predetermined fiscal targets. This could alleviate either self-imposed or externally enabled constraints on policy space and encourage the key macroeconomic policy managers at the country level to act as agents of development.<sup>16</sup> In the case of central banks, this would mean identifying ways in which equitable access to finance could be enhanced for small and medium-sized enterprises (SMEs) that represent a major source of job creation.<sup>17</sup> In the case of finance ministries, this would mean finding non-inflationary sources of finance – such as raising tax-to-GDP ratio in cases where the tax burden is low – to support much-needed public investment in infrastructure.

15. This notion is clearly reflected in the following remarks of ILO Director-General Juan Somavia: “Establishing a much closer relation between labour market developments and macroeconomic policy than we have had in the past is essential, for example, by considering employment creation a priority macroeconomic goal in the same way as low inflation and sustainable public finances.” See “Towards an employment-oriented framework for strong, sustainable and balanced growth”, a statement by Mr Juan Somavia, Director-General, International Labour Office, to the International Monetary and Financial Committee (IMFC) and the Development Committee (DC), Washington, DC, 24–25 April 2010.

16. In a number of countries, such as Indonesia, Republic of Korea and Thailand, IT regimes emerged in the wake of IMF-supported programmes. Nevertheless, their persistence well after the cessation of such programmes suggests that self-motivated restraints on policy space were also important.

17. Business environment surveys (covering 10,000 firms in 80 countries) consistently show that lack of bank finance is one of the most important constraints on the growth of SMEs (Ferranti and Ody, 2007). Note that the proposal for the central bank to find ways of enhancing access to bank finance for SMEs is more modest than a proposal that would require the central bank to be directly involved in credit allocation to preferred sectors.

## Improving the management of macroeconomic risks with a combination of prudential and protective tools

Current rethinking on macroeconomic policy recognizes that the low inflation/fiscal prudence approach has underperformed in anticipating gathering financial storms and their long-lived, deleterious effects on the real economy. The most recent estimates show that, based on past crisis episodes, it can take 5.5 years for employment to return to pre-crisis levels in developed, and three years in developing countries, to achieve the same outcome. Furthermore, in the case of developing countries, informal employment often increases during crises episodes. Such increases can take years to reverse (IILS, 2009).

The manner in which the Great Recession caught most macroeconomists by surprise highlights in dramatic fashion how relatively long periods of a low inflation environment and short, shallow business cycles as well as the rapid growth of the global economy (during 2002–07) can breed a sense of collective complacency about the future.<sup>18</sup> At the same time, a preoccupation with the hazards of macroeconomic populism, Ricardian equivalence and the crowding-out thesis led many economists to preach the virtues of monetary and fiscal policy rules that would limit the discretionary capacity of governments to engage in expansionary fiscal policies. Yet, this professional bias towards rules rather than discretion overlooked the fact that the empirical evidence in favour of either Ricardian equivalence or the crowding-out thesis was weak.<sup>19</sup> The orthodox approach was unable to attenuate the marked pro-cyclical nature of macroeconomic policies in developing countries. Furthermore, an instinctive tendency to support the cause of global financial integration led international financial institutions to either ignore or downplay the risks of pro-cyclical patterns of capital flows to developing and emerging economies.<sup>20</sup>

The community of professional economists and development practitioners now has an obligation to advocate guidelines for improved management of macroeconomic risks. These guidelines have both cautionary and protective dimensions. The prudential approach to macroeconomics suggests the following:

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18. The complacency is captured in the so-called “Great Moderation” hypothesis. Blanchard, Dell’Ariccia and Mauro (2010) acknowledge this. See also Bernanke (2004).

19. A study by the IMF based on 101 developing countries and using World Bank data covering the period 1960–95 found evidence that “large fiscal consolidations result in lower saving”. The study also concluded that the fiscal multipliers are positive, especially when accompanied by monetary expansion with limited inflationary consequences. Most significantly, “[i]ncreased government spending does not substitute for private spending, it enhances the productivity of labor and capital” (Hemming, Kell and Mahfouz, 2002).

20. On the eve of the 1997 Asian financial crisis, the IMF sought to put on the global policy agenda the issue of open capital accounts for all its member states as an eventual goal (Bhagwati, 1998).

- *Install early warning systems that would allow tracking of looming macroeconomic crises.* Based on the iconic work of Reinhart and Rogoff (2009, p. 280), a number of relatively robust early warning indicators could be used to allow central banks and finance ministries to anticipate banking and currency crises triggered by incipient asset price booms. These are: (1) real exchange rate; (2) real housing prices; (3) real stock prices; (4) short-term capital inflows/GDP; (5) current account balance/investment; (6) exports; (7) broad money/reserves. Note that the inadequacy of the IT approach becomes evident because monetary authorities will not monitor, nor act on real housing prices (2) and real stock prices (3) even if they track the real exchange rate (1).
- *Invest in data collection and dissemination to support implementation of early warning systems.* This is easier said than done. Governments will have to have the political will to invest necessary resources in developing early warning systems. When Yale economist Robert Shiller wanted to study the behaviour of real house prices, he found that he had to construct a system. This led to the now famous Case-Shiller housing price index for the US economy that goes back to 1890. It is this housing price index that enabled Shiller to become one of a handful of economists who could identify a gathering storm in the United States on the basis of an unsustainable housing price boom (Shiller, 2009).
- *Engage in “self-insurance” during booms and good times that will lead to enhanced fiscal space to deal with downturns.*<sup>21</sup> During boom times and normal periods, resources are plentiful and complacency is likely to set in. Self-insurance to enhance fiscal space in such circumstances becomes important. This can occur in many forms, such as setting aside accumulating revenues in a “stabilization fund”, drawing down debts and building up foreign exchange reserves. These precautionary savings can be used to finance discretionary fiscal interventions during downturns.
- *Temper the pro-cyclical behaviour of financial systems and external capital flows through purpose-built policy instruments* (Ocampo, 2010). The very act of self-insurance can temper the pro-cyclical behaviour of financial systems and external capital flows, but this can be reinforced by additional purpose-built instruments, such as raising the capital adequacy ratio for financial systems during a boom and implementing unremunerated reserve requirements for capital inflows.<sup>22</sup> More generally, countries should use capital controls as an important component of macroeconomic policy (Cordero and Montecino, 2010).

21. Blanchard, Dell’Ariccia and Mauro (2010) support the need for “building fiscal capacity in good times”. See also Ocampo (2010, Article 10).

22. The IMF has now recognized the importance of prudent capital account management. See Ostry et al. (2010) and the *Global Monitoring Report 2009*.

Protecting the poor and the vulnerable is crucial to the equitable sharing of the adjustment costs of macroeconomic crises. This issue is pertinent not only to developing and emerging economies. Disaggregated analysis of current unemployment and rates in the United States has shown that the global recession has hurt the poor and the near-poor while leaving the affluent largely unaffected (Sum, Khatiwada and Palma, 2010). One of the lessons learned from past crisis episodes is that a well-functioning protective approach to managing macroeconomic risks requires preparedness on the part of governments. This means, in effect, making investments in a social protection system that is both comprehensive and has components that can behave as “automatic stabilizers”, with expenditures on social protection rising in a recession and declining in a boom without recourse to discretionary interventions. It is well known that social protection systems in developing countries fall far below this ideal, but even in developed countries key aspects of the social protection system, such as unemployment compensations, are not as comprehensive as they could be.<sup>23</sup> Below is a suggested list of what needs to be done to implement a well-functioning protective approach to managing macroeconomic risks.

- *Design and implement regular “stress tests” to assess the labour market consequences of macroeconomic crises and whether policy responses can occur quickly and effectively.*<sup>24</sup> The aim is to assess alternative scenarios to simulate the impact of a contraction in output and components of aggregate demand on poverty and labour market indicators, both with and without policy responses. If properly designed and carried out, this would alert governments to existing deficiencies in the prevailing policy framework and institutional arrangements.
- *Invest in data collection and dissemination to support implementation of periodic stress tests.* A prerequisite for developing and maintaining “stress tests” is to have access to timely and reliable data on the labour market and poverty. Only 20 developing countries (only one of them in Africa) have semi-annual labour force surveys, while only 17 developing countries have up to date unemployment data and lack poverty data for 2008 and 2009.<sup>25</sup> This acute shortage of data will need to be addressed with appropriate resources and technical assistance by donors.

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23. See ESCAP (2010). For a sample of 30 countries in the region, the median coverage rate by programme (labour market programmes, assistance to the elderly, health care, social assistance, access to micro-credit, assistance to disabled, children’s protection) varies from 57 per cent (social assistance) to 5 per cent (health care). The ILO’s global database for social security shows that unemployment benefits reach less than 60 per cent of the eligible population even in high-income countries.

24. This point is emphasized by Cavallo and Izquierdo (2009). They call it the need to engage in “fire drills”.

25. Department of Statistics, ILO, Geneva.

- *Move away from fine targeting and a fragmented approach to the notion of a social protection floor.* The influential literature on targeted poverty-reduction programmes argues against adopting a comprehensive approach to social protection because it maintains that, given budget constraints, governments in developing countries should target the poor in providing income transfers and minimize “leakages” of such transfers to the non-poor and the near-poor. This approach is inadequate in coping with macroeconomic crises. Furthermore, the need to build political support for progressive social policies requires a broader conceptualization of poverty that focuses not solely on the currently poor, but also the near-poor and the interests of the burgeoning middle class in developing countries who often lack economic security.<sup>26</sup> In addition, the limitations of a fragmented approach to social protection which highlights specific policy instruments, such as conditional cash transfers or employment guarantee schemes, rather than the importance of adopting a system-wide approach, are also increasingly being recognized in the post-crisis era. Hence, the notion of the UN-supported “social protection floor” initiative which holds that all citizens in the developing world are entitled to minimal social protection coverage through both labour market and other social assistance and social insurance programmes. ILO estimates have shown that even low-income countries can afford a social protection floor with transitional donor assistance (ILO, 2009b). The challenge is to harness the necessary resources to invest in the social protection floor initiative and to ensure that it acts as an automatic stabilizer to temper the consequences of economic volatility.

### Enhance equitable access to predictable sources of external finance that respond to both macroeconomic risk management strategies and long-term development needs

Successful development is the product of national initiatives undertaken by the public sector and private actors and international cooperation. Not surprisingly, the eighth MDG is to “develop a global partnership for development”. There are five targets and 16 indicators under this goal, ranging from increasing overseas development assistance (ODA) to proposals for enhanced access of developing countries to new technologies and essential drugs.

The Great Recession has exposed the inadequacies of the existing agenda of global partnership for development. A widely held view is that lack of

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26. See Kanbur (2010). Article 9 explores the traditional theory of targeting and highlights its limitations. He argues for the case of a more comprehensive approach to social protection. See also Commission on Growth and Development: Special Report, Part 5 (Washington, DC, 2010). The vulnerability of the developing world’s “middle class” (those on above US\$2 a day) is analysed in Ravallion (2009). Birdsall (2010) provides new evidence on the middle class using higher standards than the conventional US\$2 a day.

equitable access to predictable sources of low-conditionality, quick-disbursing funds that can be made available to developing countries and emerging economies to cope with global macroeconomic volatility has contributed their tendency to engage in costly self-insurance. The result is excessive accumulation of foreign exchange reserves in a number of systemically important developing and emerging economies. This has fed into so-called global imbalances that, according to a number of observers, lie at the root of the global financial and economic crisis of 2007–08.<sup>27</sup> Thus, the implication is that unless ways can be found to enhance access to external finance that respond to macroeconomic risk management strategies in the developing world, the problem of global imbalances is likely to continue.

Furthermore, long-standing concerns about the inadequacy of ODA to meet long-term development needs have intensified in the wake of the global recession. Some studies have shown that aid volatility has increased in recent years and has thus been prejudicial to the growth prospects of low-income, aid-dependent economies (Kharas, 2008; Bulir and Hamann, 2007). Given that the fiscal position of the world's major donors has been badly impaired by the recession, there are fears that even the inadequate volumes of ODA might dwindle or its composition might shift in favour of systemically important middle-income economies suffering debt distress as a result of the global recession. This has harmful implications for low-income countries.

How has the international community responded to these concerns? At the G20 summit in April 2009, an injection of US\$1.1 trillion into the global economy was promised to “support to rescue credit, growth and jobs in the world economy”.<sup>28</sup> Close to 70 per cent of this amount went to the IMF. This will have an impact on the ability of developing countries to enhance their resources and cope with global macroeconomic volatility only if they use IMF financial assistance. The irony, as *The Economist* and others emphasize, is that the IMF is finding it difficult to attract many middle-income economies to use even their existing facilities.<sup>29</sup> Some of the quick-disbursing and low-conditionality innovations that the IMF has introduced – such as the flexible credit lines for middle income countries – are undersubscribed. There were, as of April 2010, only three countries that made use of the flexible credit line (Colombia, Mexico and Poland). In addition, the available financial statistics released by the IMF do not allow verification of just how many countries have made use of the “rapid credit line” that the IMF launched in January 2010 as an innovative, low-conditionality product for low-income economies.<sup>30</sup>

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27. Islam and Verick (2010) provide a review of the issues on global imbalances.

28. G20 Leaders' Statement, 2 April 2009, London.

29. *The Economist*: “The IMF: Battling stigma”, 26 March 2009.

30. Regular updates on IMF financial activities are available at: <http://www.imf.org/external/np/tre/activity/2010/032510.htm>.



This reticence to seek IMF assistance is largely the result of a so-called “reputational” effect. Given that the IMF has played a controversial role in past crisis management episodes, this reluctance by member States is understandable. Furthermore, critics allege that 75 per cent of the countries currently bound by IMF agreements are being subjected to a typical IMF macroeconomic stabilization-cum-adjustment programme entailing monetary restraint, fiscal austerity and structural reforms (Weisbrot et al., 2009).

In light of these limitations, what are the alternatives to using an IMF-led approach? Ideally, systematic reforms of the institutions of global economic governance are needed, as the Stiglitz Commission has argued.<sup>31</sup> In the absence of such large-scale reforms, what incremental adjustments can be made in the areas of external finance that are of direct relevance to developing countries? Below, a guide based on the pertinent literature.

- *Explore regional approaches to enhance access to external financing facilities to mitigate global macroeconomic volatility.* Advocates of this approach argue that regional cooperation is easier to generate, and also because geopolitical considerations can affect the quality of global solutions to a global economic crisis (Woo, 2008). What regional initiatives under way are relevant to fortifying the capacity of low- and middle-income countries to cope with global macroeconomic volatility? In Latin America, a Venezuela-led “Bank of the South” initiative seeks to develop regionally rooted facilities able to respond to short-term financing needs. In East Asia, there have been continuing attempts since the Chiang Mai Initiative of 2000 to develop regional cooperation to enable participating countries to tide over temporary economic setbacks engendered by external shocks. These regional innovations can be seen as attempt to offer opportunities to participating countries to seek access to fast-disbursing, low-conditionality external sources of finance without always having to go through the international financial institutions (IFIs).<sup>32</sup>
- *Diversify into alternative sources of development to complement traditional sources of ODA.* One way to do this would be to make a renewed commitment to the notion of a tax on international financial transactions (TIFT). This is, of course, an old idea first championed by Nobel Laureate James Tobin (and thus commonly known as the Tobin tax). When the idea was first mooted, it was primarily intended to identify a fiscal instrument that

31. The Commission was chaired by Nobel Laureate Joseph Stiglitz, hence its name. See Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, 6 January 2009.

32. See Weisbrot (2009) on both the Latin American and East Asian experiments in developing regional sources of development finance. For further details on the East Asian experience, see Woo (2008).

could temper the volatility associated with cross-border financial flows of a speculative nature without imposing significant efficiency losses.

Subsequent proposals for a TIFT have also focused on its potential to raise billions of dollars in development finance that could supplement traditional sources of external finance from bilateral and multilateral sources (aid and debt relief) to finance both regional and global public goods. As noted, the problem with traditional sources of development finance is that they are quite unpredictable in nature; they can be mired in onerous conditionality and compromised by geopolitical considerations. Advocates of a well-designed and well-administered TIFT see it as a particularly potent solution for circumventing the complications associated with traditional sources of development finance. Its critics, on the other hand, continue to highlight its impracticality and the risk that a TIFT could kill the proverbial goose (in this case a buoyant financial sector and deepening of financial integration) that lays the golden egg. It seems that what matters is the need for the collective political will among systemic nations to undertake the due diligence that would be necessary as a preamble to the application of a TIFT.<sup>33</sup>

## Conclusion

Given the numerous proposals on rethinking macroeconomic policy that have been put forward, the key ideas are summarized in table 1. As can be seen, there is an intellectual momentum in the post-crisis era to move away from a narrowly focused IT framework to an MDG-driven approach that gives scope for both central banks and finance ministries to make a renewed commitment to full employment within a framework of price stability and fiscal sustainability. Much greater attention needs to be given to the management of macroeconomic risks by harnessing a combination of cautionary and protective tools. This means installing early warning systems, periodic “stress tests”, complementary investments in data collection and dissemination, the use of self-insurance schemes and counter-cyclical policy instruments both during booms and normal periods, adoption of the agenda of a global social protection floor, and alternative sources of external finance to complement the role of the IMF and traditional sources of ODA.

Two closing observations are worth making. First, macroeconomic policy needs to be embedded in a holistic development strategy that seeks to promote economic diversification. Such diversification is necessary to sustain productivity-driven increases in real wages that are at the core of improving the living standards of workers and their families.

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33. Rodrik (2010) makes the point that there is growing support for a TIFT among EU members, but there is still resistance from the United States.

**Table 1. From orthodoxy to rethinking macroeconomic policy**

	<b>Goals and targets</b>	<b>Macroeconomic risk management</b>	<b>External finance</b>
Orthodox macro-economics (pre-crisis version)	Focus on maintaining low, single-digit inflation; avoid fiscal dominance because of risks posed by macroeconomic populism, Ricardian equivalence and crowding out of private investment	Policy rules, rather than discretion, can handle macroeconomic risks; counter-cyclical policy neither desirable, nor affordable for developing countries; engage in targeted social safety nets and minimize “leakages” to non-poor and near-poor even when dealing with macroeconomic crises	Replenish IMF resources and increase ODA to support national policies that engender macroeconomic stability
Rethinking orthodox macro-economics (post-crisis proposals)	Focus on the “10% rule” in increasing the pre-determined inflation target, especially for developing economies; maintain real exchange rate stability through active management of nominal exchange rate; target asset prices and monitor supply-side sources of inflation; embed MDG target 1B in operating guidelines of central banks and finance ministries; ratify ILO Convention No. 122 where such ratification is lacking	Install early warning systems to anticipate macroeconomic crises; engage in periodic “stress tests” to assess labour market consequences of macroeconomic crises; invest in requisite data collection, analyses and dissemination; use self-insurance to build fiscal capacity during good times; reinforce self-insurance by implementing counter-cyclical policy during good times; develop social protection floor and design key components of the social protection system to act as automatic stabilizers before the advent of macroeconomic crises	Go beyond IMF-led approach and traditional reliance on ODA; explore regional approaches to enhance access to low-conditionality, quick-disbursing funds; explore feasibility of complementing ODA by diversifying into new sources of long-term development finance

Second, policy-makers should consider the “construction of a framework of labour market institutions which help produce wage outcomes that, from a macroeconomic perspective, are conducive to maintaining aggregate demand and sustainable growth” (IMF and ILO, 2010, p. 75). This issue has gained a great deal of salience because declining wage share and rising wage inequality in the pre-crisis period in many developed and developing countries have contributed to global imbalances that were at the core of the global financial crisis of 2007–08.

The construction of labour market institutions that strikes the right balance between protecting workers’ rights and promoting growth will need to ensure that “real wages in aggregate ... grow more or less in line with productivity” (ibid.). This will mean strengthening mechanisms for wage determination through reinvigorated minimum wage policy, social dialogue and collective bargaining at the enterprise and industry level and tripartite consultations and negotiations on economic and social policies. Strengthening the wage determination process along such lines is likely to lead to stable unit

labour costs. This can confer triple benefits: (a) preservation of international competitiveness, (b) sustaining aggregate demand by acting as a bulwark against declining wage share, and (c) sustaining reasonable price stability. Hence, appropriately designed labour market institutions can play a critical role in a pro-employment macroeconomic framework.

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## Appendix

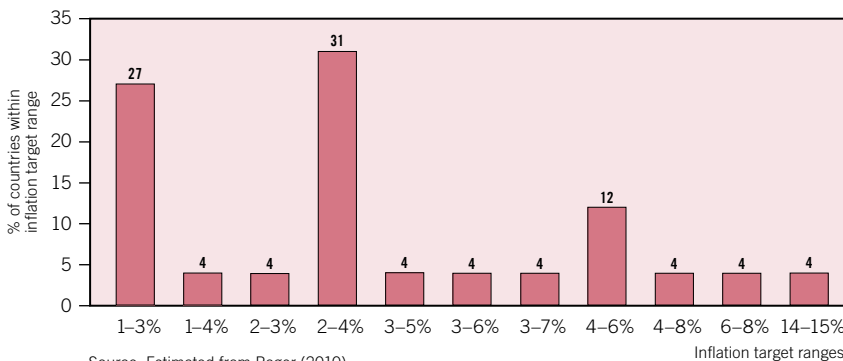
Macroeconomic policy for full and productive employment and decent work for all

**Table A1. Inflation targeting countries**

Country	Target inflation rate	Average target
Australia	2–3	2.5
Brazil	2.5–6.5	4.5
Canada	1–3	2
Chile	2–4	3
Colombia	2–4	3
Czech Rep.	2–4	3
Ghana	13.5–15.5	14.5
Guatemala	4–6	5
Hungary	2–4	3
Iceland	1–4	2.5
Indonesia	4–6	5
Israel	1–3	2
Korea, Rep. of	2–4	3
Mexico	2–4	3
New Zealand	1–3	2
Norway	1.5–3.5	2.5
Peru	1–3	2
Philippines	3.5–5.5	4.5
Poland	1.5–3.5	2.5
Romania	2.5–4.5	3.5
Serbia	4–8	6
South Africa	3–6	3
Sweden	1–3	2
Thailand	0.5–3	1.75
Turkey	5.5–7.5	6.5
United Kingdom	1–3	2
Median inflation target (all countries, 26)		3
Median inflation target (emerging and developing countries, 17)		3
Average inflation target		3.6

Source: Estimated from Roger (2010), pp. 46–49.

**Figure A1. Frequency analysis of inflation target ranges**



Source: Estimated from Roger (2010).

**Table A2. Median growth and inflation rates for high-, medium- and low-growth countries**

	<b>Growth category and number of countries (in parentheses)</b>	<b>Growth median (%)</b>	<b>Inflation median (%)</b>
1980–1989	High growth (14)	7.3	7.4
	Medium growth (34)	3.9	9.4
	Low growth (69)	1.6	11.8
1990–1999	High growth (16)	6.4	11.3
	Medium growth (57)	4.3	8.7
	Low growth (48)	1.6	16.9
2000–2007	High growth (40)	7.7	5.8
	Medium growth (74)	4.6	5.7
	Low growth (31)	1.8	3.0
1980–2007	High growth (12)	6.6	7.6
	Medium growth (55)	4.2	8.6
	Low growth (47)	2.1	15.7

Note on sample sizes: 117 countries for 1980–89 period; 121 countries for 1990–99 period; 145 countries for 2000–07 period; 114 countries for 1980–2007 period. Countries classified into performance categories based on growth rates (good = above 6 per cent; medium = between 6 and 3 per cent; low = under 3 per cent).

Source: Estimated from IMF World Economic Outlook Data 2009.



# The crisis in the euro area

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The impact of the international financial crisis on workers in the euro area was for a time relatively limited. In the United States, many firms responded to the crisis with rapid cuts in employment. In Eastern Europe a number of countries that were members of the European Union (EU), but not protected by membership of the euro area, faced savage cuts in output and employment, most especially in the Baltic region. In many euro area countries, by contrast, the rise in unemployment was much more moderate – the main exceptions being Ireland and Spain where, following the bursting of house-price bubbles, unemployment did rise significantly. In May 2010, however, a supposed crisis of the euro, sparked by concerns about Greek sovereign debt, initiated a major shift. This led to cuts in wages and public spending in peripheral euro area countries and was followed by the announcement of plans to shift to policies of fiscal consolidation in much of the rest of the euro area.

This article first outlines the main stages of the recent crisis in the euro area, starting with the financial crisis and then moving on to the economic crisis and the subsequent debt crisis and its impact. It then turns to consider two areas of policy. The first concerns how to respond to the significant imbalances which have developed between euro area countries; the second is concerned with the vulnerability of even the euro to speculation in the current international monetary system.

### Financial crisis

As is well known, the recent financial crisis originated in the United States as a result of the failure of complex securities based on so-called subprime mortgages – housing loans extended predominantly to low-income households that did not fulfil the requirements to obtain a standard mortgage. The crisis broke in August 2007 when lending dried up in the interbank money market, the market where banks lend funds between themselves, and which is the central pivot of a modern capitalist banking system. Banks stopped lending to each other because of their concerns that other banks might have made large losses on investments in the mortgage-backed securities and therefore be unable to repay any loans. The Federal Reserve and the European Central Bank attempted to prevent a breakdown of the money markets by immediately increasing their lending to banks so that there would be more liquidity in the market. This did prevent a breakdown of the money market but, as banks revealed ever larger losses, they sharply curtailed their lending to non-financial enterprises. The crisis deepened dramatically in September 2008, when the collapse of the New York investment bank, Lehman Brothers, set off a chain of financial failures, including that of American International Group Inc (AIG), the insurance giant, which had insured many of the securities held by banks in the United States and in the euro area.

Although the crisis originated in the United States, European banks were deeply affected by it because they had also engaged in extensive financial investments in that country. Large European banks had aggressively expanded their international business since the late 1990s, and the United States was by far the most important economy in which they were active. This expansion was promoted by the policies of the European Commission. After the introduction of the euro in 1999, the European Commission launched an ambitious programme, known as the Financial Services Action Plan, to create an integrated financial system in the euro area (Frangakis, 2009). The Commission had been very impressed by the information technology boom in the United States in the late 1990s, and by the role that the financial system appeared to have played in enabling it to occur in that country. The Commission's proposals for financial reform in Europe were, consequently, strongly influenced by the American model, giving priority to promoting market-based forms of finance, and encouraging financial institutions to become more competitive.<sup>1</sup> In this context, as European financial institutions adopted more competitive strategies they eagerly sought the apparently high returns available from US mortgage-backed securities. However, when many of these securities began to fail in 2007, the banks registered huge losses. According to estimates by the International Monetary Fund (IMF), the total losses incurred by euro area banks between 2007 and 2010 amounted to US\$630 billion, not far behind the figure for American banks of US\$878 billion (IMF, 2010a).

At the peak of the crisis in early October 2008, the international financial system was widely considered to be on the edge of collapse and, in order to avert this, governments responded by injecting capital directly into banks which was in effect a partial nationalization of the institutions concerned. At the same time, governments provided guarantees for bank lending in an attempt to get the interbank market functioning again and assumed responsibility for the value of dubious financial assets. The total commitment by euro area governments amounted to some €2.1 trillion, equal to 28 per cent of the area's gross domestic product (GDP) – the figure for the United States was 26 per cent. In fact, as shown in table 1, the commitments have only partly been drawn on, although the amounts involved are still very large.

**Table 1. Euro area government support for the financial sector, October 2008–May 2010**

	Committed €billion	Implemented €billion	Implemented %
Capital injections	231	84.2	36
Liability guarantees	1694	506.2	30
Asset protection	238	48.7	20

Source: Stolz and Wedow (2010), table 1, p. 24.

1. Historically, companies in continental Europe have drawn mainly on banks for external finance, whereas in the United States they have been more reliant on raising funds in the capital market, mainly by issuing bonds.

This decisive government intervention was successful in breaking the chain of financial failures which had followed the collapse of Lehman Brothers. However, the acute sharpening of the financial crisis also had a major impact on the rest of the economy and led to the most serious economic recession since the 1930s.

### Economic crisis

At the end of 2008, the euro area economy suffered a major slump, with output falling by almost 5 per cent – an even greater decline than that of the United States. The slump was due to two main factors. First, prior to the crisis, growth in the euro area had been especially dependent on international trade and, exacerbated by a collapse of trade credits, euro area exports fell by around 20 per cent – amongst developed economies only Japan, with a fall of 30 per cent, suffered a larger decline. Second, the acute problems faced by the banking sector led to a collapse in the provision of credit for non-financial companies, something which affected even the biggest and best known companies. Given the radically uncertain outlook, firms sharply cut back their fixed investment, which fell by 11.3 per cent between 2008 and 2009.<sup>2</sup> In addition, in Ireland and Spain, the two euro area countries where economic growth had been closely associated with a major housing boom, the bubble in house prices burst, leading to a dramatic contraction in the building industry.

As a result of the recession, unemployment began to rise. For the euro area as a whole, the unemployment rate increased from 7.5 per cent in 2007 to 9.4 per cent in 2009. Some countries managed to limit the increase, most notably Germany, which adopted a very successful government-financed programme of short-time working. However, unemployment increased especially strongly in the two countries where bubbles in house prices had burst. In Ireland, which had enjoyed almost a decade of historically low unemployment, the unemployment rate rose from 4.6 per cent in 2007 to 11.9 per cent in 2009; while in Spain it increased from 8.3 to 18.0 per cent over the same period.<sup>3</sup>

Governments in the euro area, as in other countries, responded to the slump in output by adopting expansionary fiscal programmes, with varying combinations of increased government spending and reduced taxes. The French Government had initially proposed a joint European expansion but this was opposed, among others, by Germany, the result being that each country initiated its own programme. Although the European Commission likes to claim that there was a coordinated response to the crisis, the reality

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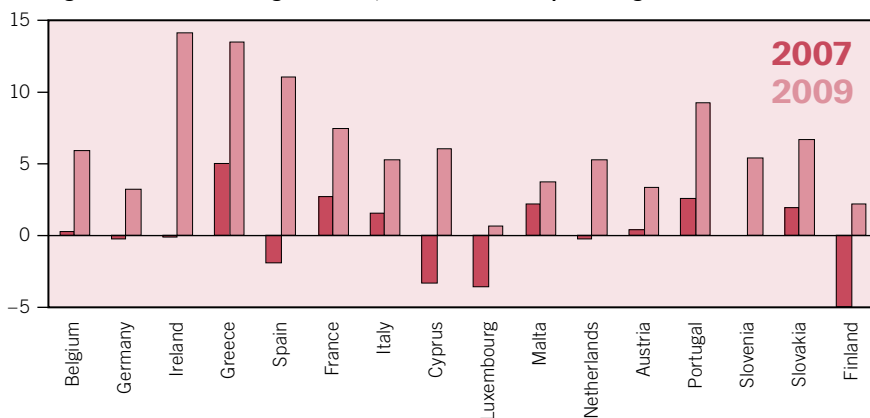
2. Gross fixed investment in the euro area fell by 11.3 per cent between 2008 and 2009 (Eurostat).

3. Eurostat data series tsiem110.

is that each country jealously guarded its fiscal autonomy, and the decisive measures were determined at a national level.<sup>4</sup> In the event, Germany’s programme was actually one of the larger ones, providing a boost to the economy equal to 1.7 per cent of GDP in 2009 (with another 2.4 per cent expected in 2010), while the average for the whole European Union was 1.5 per cent in 2009 (with 1.4 per cent expected in 2010) (European Commission, 2010). This was, however, considerably more cautious than the expansionary programme introduced in the United States, which was equal to some 3 per cent of GDP in 2008 and 2009.

The expansionary fiscal programmes helped to cushion the impact of the recession, partly compensating for the sharp fall in aggregate demand arising from the decline in investment and exports. However, government budgets had already been hit by the cost of the rescue packages for the financial sector, and now with the cost of the expansionary fiscal programmes, together with rising spending on benefits and a decline in tax revenues as a result of the recession, fiscal deficits increased across the euro area. As can be seen in figure 1, in 2007 only one country (Greece) had a government deficit which exceeded 3 per cent of GDP (the limit set by the euro area Growth and Stability Pact), and the figure for the euro area as a whole stood at just 0.6 per cent. By 2009, however, deficits had shot up, with the figure for the euro area rising to 6.6 per cent of GDP. Only Finland and Luxembourg had deficits below 3 per cent, while those in Greece, Ireland and Spain were over 10 per cent with Portugal only slightly behind.

Figure 1. Euro area budget deficits, 2007 and 2009 (percentage of GDP)



Source: Eurostat.

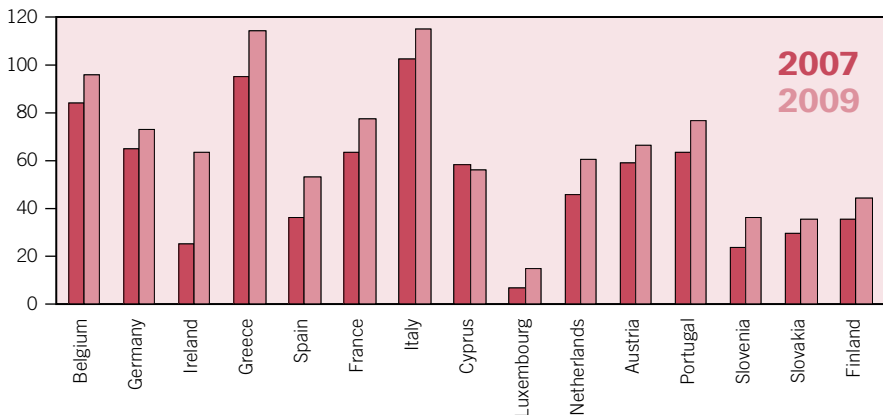
4. The so-called “European Economic Recovery Plan” was proposed by the European Commission in November 2008 and approved by the European Council in December 2008. The European Union itself is unable to pursue an expansionary fiscal policy since its budget amounts to only about 1 per cent of the Union’s GDP.

The recession in the euro area ended in mid-2009. In the second half of the year output finally began to rise again and growth strengthened in the first half of 2010. Nevertheless, output remained below the level it had reached prior to the onset of the crisis and, while the unemployment rate did edge downwards in some countries, most notably Germany, in the euro area as a whole it continued to increase. Despite the fragile nature of the recovery, European finance ministers' meeting in December 2009 agreed that it was necessary to begin preparing for an "exit" from the expansionary programmes, and concern about the burden of rising government debt began to become a major issue.

### Debt crisis

The increase in government deficits as a result of financial rescues, fiscal expansion and falling tax revenues led to a notable rise in government debt in the euro area (figure 2). The most striking case was that of Ireland where government debt stood at only 25 per cent of GDP before the onset of the crisis, one of the lowest in the euro area. However, the size of Ireland's banking system was especially large in relation to the country's economy and, following the bursting of the bubble in property prices, banks suffered huge losses. The Government intervened to prevent a collapse of the banking system and, principally due to expenditures rescuing banks, the Government debt had increased to 64 per cent of GDP by 2009. The Irish Government was able to finance its bank rescue programmes by drawing on large liquid reserves at the National Pensions Reserve Fund and the National Treasury Management Agency (*Financial Times*, 2010a). Nevertheless, as part of a plan to reduce its massive fiscal deficit to below 3 per cent of GDP by 2014,

Figure 2. Euro area government debt, 2007 and 2009 (percentage of GDP)



Source: Eurostat.

in December 2009 the Government introduced an austerity budget involving swinging cuts in wages, pensions and other government expenditure – the first such cuts in the euro area.

At the end of 2009, attention switched from Ireland to Greece's public debt. The new Socialist Party administration, elected in October, revealed that the country's large budget deficit had been seriously understated by the previous government. Since joining the euro area in 2001, the Greek Government had been able to borrow at an interest rate only slightly higher than the German Government. In December 2009, however, as Greek bonds began to be seen as more risky, the margin over German rates increased to 1.8 per cent and the three leading international ratings agencies all downgraded their assessment of Greek public debt. In the early months of 2010, financial investors began to speculate that Greek bonds might fail by buying credit default swaps (CDS) – a form of insurance against bonds failing which do not require you to actually own the bond in question. As rising demand pushed up the price of CDS, this was taken as evidence of a heightened risk that the bonds might fail and Greek interest rates, in turn, were pushed up yet further. At the same time, doubts about the willingness of other euro area governments to support Greece, and the implications this might have for the future of Europe's common currency, prompted speculation against the euro, whose value declined from US\$1.50 to US\$1.20 in the space of a few months.

The situation came to a head in April 2010 when it became clear that re-financing Greek government debt that was due to expire in mid-May would be prohibitively expensive. The interest rate that Greece would have to pay in financial markets rose in the course of April from 6.5 per cent to 10 per cent – almost 7 per cent above the German rate.<sup>5</sup> As other euro area governments failed to respond to proposals to provide Greece with support, principally because of opposition from Germany, the euro continued to weaken in response to intensified speculation. Finally, after Dominique Strauss-Kahn, Managing Director of the International Monetary Fund (IMF), and Jean-Claude Trichet, President of the European Central Bank (ECB), paid a joint visit to Germany's Chancellor, Angela Merkel, and convinced her of the seriousness of the situation, euro area governments agreed in early May to provide Greece with €110 billion support. This was the amount which it was estimated would be required to meet the country's financing needs for the following three years. At German insistence, but against the initial opposition of the ECB, the IMF participated in the programme, contributing €30 billion of the financing and, crucially, playing a key role in establishing the conditions which Greece would have to meet.

Despite the scale of the support for Greece, speculation against the euro intensified. It was feared that Greece might still default on its debt and, in addition, concerns mounted about the foreign liabilities incurred by Portugal

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5. Ten-year government bond yield, from [www.bloomberg.com](http://www.bloomberg.com).

and Spain. These last two countries did not have large deficits before the crisis (Spain actually had a budget surplus), but they had run up very large deficits responding to the crisis. In addition, in the case of both countries, the private sector, banks in particular, had run up large foreign debts. The banks which had lent the money, mainly in northern Europe, began to see their shares fall in value, and the price of insuring bank bonds increased to levels last seen at the time of the failure of Lehman Brothers in 2008. Finally, at a specially convened weekend meeting, and after much urging by the President and Treasury Secretary of the United States, concerned by a possible widening of the crisis, the euro area governments agreed to set up a €440 billion European Financial Stability Facility (EFSF).<sup>6</sup> This would raise funds by issuing bonds, with guarantees from euro area countries in proportion to the size of their economies, and make financing available to countries in difficulty, but with tight conditions. At the same time, the European Union agreed to make a further €60 billion available for balance of payments support and the IMF offered up to €250 billion in loans, providing a total package amounting to €750 billion.

Shortly after the package was announced in the early hours of Monday, 10 May 2010, the ECB also made a key contribution to resolving the crisis by announcing that it would begin to purchase government bonds, a policy which was opposed by Axel Weber, the head of the German Bundesbank and a member of the ECB's governing council, because he considered that this step risked stoking inflation. ECB purchases of government bonds, primarily those issued by Greece, Ireland, Portugal and Spain, played a significant role in stabilizing the bond market although, because the purchases were largely sterilized, they did not have an effect on the ECB's total lending to the banking system.<sup>7</sup>

The so-called crisis of the euro was triggered by difficulties associated with financing the public debt of one of the euro area's smaller economies. It threatened to develop into a more serious crisis because of the apparent unwillingness of euro area governments and the ECB to take responsibility for the stability of their common currency. Once the political will to act had been demonstrated with the creation of the EFSF and the ECB's willingness to support bond markets, the crisis abated. With euro area interest rates above those in the United States, the euro appreciated in the second half of 2010, recuperating much of the previous decline. Although the crisis was not planned, it served to provide the dramatic conditions in which several peripheral European countries were obliged to adopt a major shift in their economic policy involving significant cuts in wages and public spending and which look set to augur a social crisis for those that will be most affected.

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6. For details of the role of the United States in pushing euro area leaders to expand the scale of the proposed package, see *Financial Times* (2010b).

7. Sterilization involved the ECB selling an equal amount of other financial assets, so that the total amount of finance provided to the markets by the ECB was not affected.



## Austerity and fiscal consolidation

Major cuts in public spending were first introduced in the euro area by Ireland, where the Government had incurred huge expenditure as a result of its commitment to rescuing the country's over-blown banking sector. In December 2009, the Government introduced an austerity budget designed to cut the fiscal deficit from almost 12 per cent of GDP in 2009 to 3 per cent by 2014, principally by cutting spending. The measures involved reducing civil servants' pay by between 5 per cent for those earning below €30,000 a year and up to 20 per cent for those with higher incomes. The budget also included cutting welfare payments by 4 per cent and child benefits by 10 per cent (*Financial Times*, 2009). In September 2010, the Government intervened yet again to support the country's largest bank, Anglo Irish, bringing total spending on bank support to €30 billion. As a result, the country's fiscal deficit for 2010 looked set to rise to an unprecedented 32 per cent of GDP and the Government announced plans for yet another round of budget cuts (*Financial Times*, 2010c).

In Greece, the rescue package negotiated with the euro area and the IMF required the Government to cut the country's fiscal deficit from 13.6 per cent of GDP in 2009 to below 3 per cent by 2014.<sup>8</sup> Spending is to be cut by 5.25 per cent of GDP through to 2013, principally by reducing public-sector wages and pensions and then freezing them for three years.<sup>9</sup> Social security payments will also be reduced. Revenue is to be increased by 4 per cent of GDP through to 2013 by raising sales taxes. Improved tax collection, especially among higher income groups which pay notoriously little tax in Greece, is to raise revenue by 1.8 per cent of GDP through to 2013. The plan envisages a contraction of GDP by 4 per cent in 2010 and 2.6 per cent in 2011 (IMF, 2010b).

In Spain, following intense pressure from the European Union, the IMF and the United States Government, the Government announced a major austerity programme within days of the creation of the €440 billion EFSF. The programme aimed to reduce Spain's fiscal deficit from 11.2 per cent of GDP in 2009 to just over 6 per cent in 2011. The main feature was that public-sector salaries would be cut by 5 per cent and then frozen for a year. The programme also envisaged a €6 billion cut in public investment, €1.2 billion cuts in spending by local and regional governments, a freeze on pensions and the abolition of a childbirth allowance (*Financial Times*, 2010d).<sup>10</sup>

8. In November 2010 Eurostat raised its figure for Greece's government deficit in 2009 to 15.4 per cent of GDP.

9. The 13th and 14th months' salary would be eliminated and employees with an income below €3,000 would be compensated with bonuses totalling €1,000 a year. Employees of publicly owned companies will see their wages cut by 3 per cent. Pensioners will lose the 13th and 14th monthly holiday payments with compensating payments totalling €800 for those with a pension under €2,500 (Bloomberg, 2010).

10. The proposals also included cuts of 15 per cent in the salaries of senior government ministers.

Spain was followed immediately by Portugal, which announced a plan designed to cut the fiscal deficit from 9.4 per cent of GDP in 2009 to 4.6 per cent by 2011. Under the plan, public-sector salaries will be cut by 5 per cent, and there will be an increase in income taxes (raised by up to 1.5 percentage point), sales taxes (up 1 percentage point to 21 per cent), and corporation tax (up 2.5 percentage points to 27.5 per cent on profits over €2 million) (*Financial Times*, 2010e).

The spending cuts in Ireland, Greece, Portugal and Spain are especially serious because they all involve actually reducing incomes. In the aftermath of the Greek crisis, however, the larger euro area governments also announced plans to reduce their fiscal deficits, principally by cuts in expenditure. In May, Italy announced plans to cut public spending by €24 billion and to freeze public-sector wages for three years. In June, Germany announced its intention to reduce government spending by €80 billion over three-and-a-half years, and France announced plans to cut its deficit to 3 per cent of GDP by 2013 by introducing a spending freeze and a reform of the pension system. Most unusually, even the IMF, normally one of the strongest proponents of fiscal orthodoxy, has warned that such widespread fiscal consolidation might tip Europe back into recession (IMF, 2010c). In contrast to much of the euro area, the German economy grew strongly in 2010, with a large rise in its exports. This was partly due to the demand from Asia, but the main market for German exports remains the euro area and the country will therefore also not be immune to the impact of a renewed downturn in European demand.

### Polarization in the euro area

Membership of the euro area led to a decline in interest rates for countries such as Ireland, Portugal and Spain after 1999, and for Greece after it joined the euro area in 2001, and this contributed to growth rates above those in the larger northern economies in the years up to 2007. When Greece was faced with problems in refinancing its public debt in 2010, the authorities in the euro area portrayed this as arising primarily from policy deficiencies within the country. As noted above, Greece had for some years had quite a large fiscal deficit and, as a result, had accumulated a high public debt in relation to GDP.<sup>11</sup> It also had a large current account deficit. However, the problems faced by Greece – and subsequently by other peripheral euro area countries – were also due to being the weakest link in a chain of imbalances within the euro area.

At one end of the spectrum is Germany. For many years after the Second World War, real wages in Germany increased roughly in line with

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11. The public deficit was, however, not so much due to high spending (which was around the average for the European Union as a share of GDP) but rather to low tax revenues, in particular due to the failure to tax the better-off.

productivity. Since the 1990s, however, this relationship has broken down, and this has been especially marked since around 2000. As can be seen in table 2, between 2000 and 2007 real wages were virtually stagnant while productivity increased, so that real unit labour costs fell. This resulted in a significant distributional shift from wages to profits and, because domestic demand failed to grow in line with output, economic growth in Germany was strongly dependent on generating an export surplus. In nominal terms, wages increased a little less than labour productivity. As a result, nominal unit labour costs declined slightly, giving Germany a strong competitive advantage against its trading partners.

In the peripheral European countries, by contrast, nominal compensation increased more than productivity between 2000 and 2007. In the case of Greece (and also Ireland), labour productivity actually increased strongly during these years, rising more than in Germany. Nevertheless, because nominal compensation rose even more than productivity, nominal unit labour costs increased considerably, weakening the countries' international competitiveness. In Portugal and Spain, productivity growth was considerably more muted but, as nominal wages also rose more rapidly than productivity, nominal unit labour costs rose in those countries too. At all events, with relatively strong demand in several countries, and a declining international competitiveness, Greece, Portugal and Spain registered rising trade deficits. Ireland had a trade surplus, but because of the large outflows of income, principally associated with the repatriation of profits to foreign multinationals, it also had a strongly rising current account deficit during this period.

The differing evolution of wages and productivity in the euro area was accompanied by the emergence of significant trade imbalances within the euro area. Between 2000 and 2007, when Germany's nominal unit labour costs were almost unchanged, its trade surplus increased strongly. At the same time,

**Table 2. Changes in compensation, productivity, unit labour costs and prices, 2000–07 (percentages)**

	Nominal compensation	Productivity	Unit labour costs	Consumer prices	Real compensation*
Austria	17.4	12.9	4.0	14.6	2.8
Belgium	21.2	7.1	13.2	15.1	6.1
France	24.9	9.8	13.8	13.4	11.5
Germany	9.6	12.8	-2.8	12.1	-2.5
Greece	47.0	18.0	24.6	25.5	21.5
Ireland	54.7	20.8	28.0	29.6	25.1
Italy	22.6	1.2	21.2	17.2	5.4
Netherlands	28.6	12.3	14.5	16.2	12.4
Portugal	25.2	7.7	16.3	23.4	1.8
Spain	31.6	5.9	24.3	24.7	6.9

\* Change in nominal compensation less change in consumer prices.

Source: OCDE StatExtracts.

in Greece, Portugal and Spain, where nominal unit labour costs were rising, the trade deficit increased (in Ireland, the current account deficit increased). As illustrated in figure 3, the growth of Germany's trade surplus and the southern European peripheral countries' trade deficit between 2000 and 2007 mirror each other closely, with both declining after the onset of the crisis.

The large deficits of the southern euro area countries were financed to a significant extent by bank lending, much of which came from the larger countries of northern Europe. By March 2010 total bank lending to the four peripheral countries amounted to US\$2.6 trillion, with Spain alone accounting for US\$1.1 trillion (see table 3). In the case of Greece, around one third of the lending was to the public sector, but in the other three countries, the lending was overwhelmingly to private-sector borrowers, in many cases banks that were refinancing their domestic lending from abroad. The largest lenders were banks in Germany and France, both of which had an exposure

Figure 3. Trade balance, 2000–09 (€ billions)

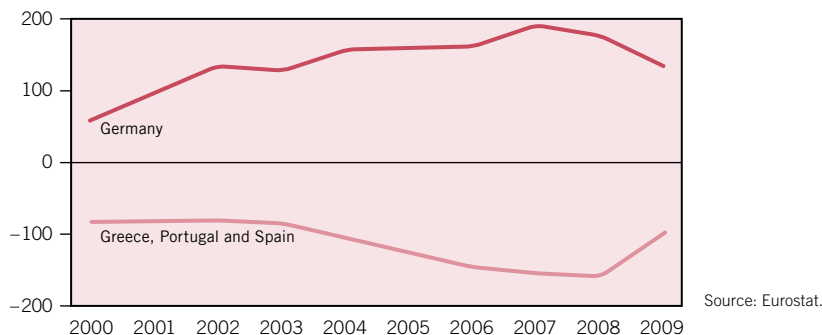


Table 3. Bank exposure to Greece, Ireland, Portugal and Spain (March 2010, US\$ billions)

		Bank nationality									Total
		Germany	Spain	France	Italy	Other euro	UK	Japan	US	Rest of world	
Greece	Public sector	23.1	0.9	27.0	3.3	22.9	3.6	4.3	5.4	2.0	92.5
	<b>Total</b>	<b>51.0</b>	<b>1.6</b>	<b>111.6</b>	<b>8.8</b>	<b>47.9</b>	<b>16.5</b>	<b>5.9</b>	<b>41.2</b>	<b>12.7</b>	<b>297.2</b>
Ireland	Public sector	3.4	0.2	8.7	0.9	3.8	7.3	1.8	1.9	1.8	29.7
	<b>Total</b>	<b>205.8</b>	<b>16.2</b>	<b>85.7</b>	<b>28.6</b>	<b>92.5</b>	<b>222.4</b>	<b>22.9</b>	<b>113.9</b>	<b>55.8</b>	<b>843.8</b>
Portugal	Public sector	9.9	10.6	20.4	2.2	11.5	2.6	2.3	1.6	1.7	62.9
	<b>Total</b>	<b>46.6</b>	<b>108.0</b>	<b>49.7</b>	<b>9.4</b>	<b>29.1</b>	<b>32.4</b>	<b>4.0</b>	<b>37.3</b>	<b>6.0</b>	<b>322.4</b>
Spain	Public sector	30.0		46.9	2.3	19.1	7.6	12.5	4.9	4.4	127.6
	<b>Total</b>	<b>217.9</b>		<b>244.2</b>	<b>42.5</b>	<b>200.6</b>	<b>141.7</b>	<b>30.0</b>	<b>186.4</b>	<b>39.3</b>	<b>1102.6</b>
Total	Public sector	66.4	11.7	103.0	8.7	57.3	21.1	20.9	13.8	9.9	312.7
	<b>Total</b>	<b>521.3</b>	<b>125.8</b>	<b>491.2</b>	<b>89.3</b>	<b>370.1</b>	<b>413.0</b>	<b>62.8</b>	<b>378.8</b>	<b>113.8</b>	<b>2566.0</b>

Source: BIS Quarterly Review, Sep. 2010.

of around US\$500 billion. American banks also had a considerable exposure, especially to Spain, perhaps indicating why the United States authorities pressed euro area governments so strongly to establish the EFSF.

The imbalanced economic growth in the euro area has therefore depended on extensive bank lending. In Germany, where low-wage growth made the economy dependent on generating an export surplus, this was made possible by German (and other) banks lending money to peripheral European countries, which were thereby able to finance trade and current account deficits. When the debt crisis developed, first in Greece and subsequently in Portugal and Spain, it was therefore a problem not only for the country concerned; it was also a problem for the countries of Northern Europe, where banks were faced with the prospect of a further source of losses, something that could in turn have required additional support for the banks from the governments of the countries concerned.

The widening divergences between the members of the euro area demonstrate the need for a more coordinated approach to economic policy. The Growth and Stability Pact, which requires euro area governments to maintain a fiscal deficit below 3 per cent of GDP, is quite unable to deal with the imbalances between countries. Attempting to deal with such imbalances by forcing countries with a deficit to implement deflationary policies will, ultimately, also harm the surplus countries, such as Germany, which depend on the euro area market. Indeed, Germany is one of the countries that have most benefited from the euro since its principal trade partners are now locked into irrevocable exchange rates.

There are a number of steps that could be taken (EuroMemorandum 2010/2011). In place of the now discredited Growth and Stability Pact, the euro area countries must develop a coordinated economic policy which aims to promote full employment. A key feature of such a policy should be public-led investments aimed at a profound ecological transformation which addresses the urgent challenge of climate change. In the short term, existing institutions can be drawn on, including the European Investment Bank (EIB), to provide the finance for such investment. In addition, as suggested by the European Trade Union Congress, the EFSF could be drawn on to finance investments that reduce the likelihood of a further crisis in the euro area, rather than awaiting the need to mount a rescue when the next crisis occurs (ETUC, 2010). Financing a major investment programme should not be difficult, provided this is conducted at the level of the European Union or the euro area. In fact, credit-worthy borrowers (such as Austria, Germany, the Netherlands and the EIB) are now able to borrow at rates that are even lower than those prevailing at the outset of the crisis. The pressure on individual countries could also be reduced by issuing euro bonds, jointly backed by all euro area countries, to cover at least a part of all Member States' government debt. This would enable weaker countries to gain the benefits of the lower interest rates enjoyed by the stronger states.

In the longer term, the crisis demonstrates the need for new institutions in the European Union. To this end, the capacity to conduct fiscal policy at the level of the Union – or at least the euro area – should be strengthened by a partial centralization of fiscal policy, with the EU budget being expanded to around 5 per cent of EU GDP. Such a step could be financed, at least partly, by the introduction of a tax on financial transactions and on the use of energy. However, fiscal transfers that go beyond the very limited payments associated with the EU’s regional policy (currently about 0.4 per cent of EU GDP) will also be required. Such transfers are economically necessary if the monetary union is to function; they are also politically necessary if social cohesion in Europe is to be sustained.

### Currency rivalry

The abrupt shift in euro area policy at the time of the Greek debt crisis, and the agreement to provide support to Greece and then to set up the EFSF, was partly due to the delay in the political response. However, the dramatic edge imparted to the situation was a result of the emergence of speculation against the euro. The current international system based on the US dollar and private financial markets is highly vulnerable to large shifts in sentiment by the financial investors who dominate the markets.

Between 2002 and 2008 the euro appreciated steadily against the US dollar. For much of this time, interest rates in the euro area were higher than those in the United States. Although the United States authorities claim that they favoured a strong dollar, in practice they appeared to welcome the weakening of their currency as it led to an improvement in the country’s trade balance. However, this can be a dangerous strategy, as was evidenced in 1979 when a policy of allowing the dollar to weaken spun out of control as investors dumped their holdings of the US currency.

Figure 4. Euro–US dollar exchange rate



Source: European Central Bank.

When the global financial system appeared on the edge of collapse following the failure of Lehman Brothers in September 2008, large sums of money flowed back into the dollar in a so-called “flight to safety”. In that moment of acute crisis, US government bonds were seen as the most secure financial asset available and the euro depreciated by around 20 per cent. However, as the threat of global financial collapse receded in early 2009, the euro recovered most of its lost value, aided by the fact that euro area interest rates were higher than those in the United States.

As a result of the outbreak of uncertainty about Greek debt at the end of 2009 and the prolonged delay before the euro area authorities responded, financial investors began to engage in extensive forward selling of the euro, and in the first half of 2010 the currency depreciated yet again by 20 per cent. As noted above, even after the euro area governments agreed to provide financial support for Greece, the pressure against the euro continued and only abated after the €440 billion EFSF was established. As can be seen in figure 5, although the euro then strengthened in the second half of 2010, at the end of the year, when Ireland and then Portugal came into investors’ sights, the euro began to weaken again.

Several Eastern European States that were members of the European Union, but not of the euro area, had faced the threat of currency crises in 2008, and had been obliged to adopt severe austerity programmes in order to obtain assistance from the International Monetary Fund. This was the case in Hungary and the Baltic States. However, it was assumed that membership of the euro area, the second most important reserve currency in the world, would provide countries with protection against facing such currency crises. Surveys in countries such as Denmark and Sweden, where public opinion had been hostile to joining the euro area, indicated a shift in favour of joining the larger currency bloc after the onset of the crisis in order to share in the protection it could offer (Munchau, 2008). However, the speculation which developed against the euro demonstrates that even it is not immune from the huge pressure that can be exerted against currencies by private financial institutions.

The most recent financial crisis and the fact that it originated in the United States has led to renewed questioning of the current organization of the international monetary system and the leading role of the US dollar. In March 2009, shortly before the G20 was due to meet in London for a major summit on how to respond to the crisis, a commission set up by the United Nations and chaired by Joseph Stiglitz published proposals for establishing a new global reserve system based on an expanded role for Special Drawing Rights (UN General Assembly, 2009). Just one week before the G20 meeting, the Governor of the People’s Bank of China, Dr Zhou, also published a paper proposing that the world should move towards a more truly international system, in which the role of the dollar would be superseded by building on the IMF’s Special Drawing Rights (Zhou, 2009).

The creation of the euro was motivated, in part, by the desire to establish a currency bloc that would be large enough to withstand the speculative dynamics which drive private financial markets and, in this way, to gain greater policy autonomy for European governments. Developments on the foreign exchange market in 2010 demonstrated that, even though it is the world's second most important reserve currency, the euro is not exempt from the pressure exerted by private investors. If economic democracy is to be strengthened in Europe it will therefore be necessary to build support for constructing a new international monetary order that is not subject to the vagaries of the dollar and huge international flows of private capital.

## Conclusions

The financial and economic crisis did not initially lead to such a rapid rise in unemployment in the euro area as in the United States, but government responses to the crisis led to rising fiscal deficits. When Greece was faced with problems in refinancing its public debt, the failure of the euro area authorities to respond rapidly led to speculation against the euro and threatened a currency crisis. Although the crisis was not planned, it provided the occasion for a major shift in policy in Europe, and first Greece and then Portugal and Spain were obliged to introduce tough austerity programmes. Ireland, which had already introduced a severe austerity programme in 2009, had to introduce a further, even more severe programme at the end of 2010. At the same time, other euro area countries announced plans to reduce their fiscal deficits to below 3 per cent of GDP, in most cases by 2013. Although Germany has registered strong growth in 2010, the impact of the austerity programmes and widespread cuts in public spending risk, at best, a prolonged period of low growth and high unemployment for the euro area as a whole.

The problems in the peripheral European countries are not simply the result of developments within these countries but also reflect major imbalances in the euro area. Prior to the crisis, Germany followed a strategy of low wage growth and depended on a large export surplus to sustain demand; the peripheral European countries, which supplied part of that demand, had trade deficits which were made possible by bank lending from other countries, of which Germany was the most important. This was not sustainable. But forcing adjustment on the peripheral countries will not only increase unemployment and social hardship in those countries; it also threatens deflation throughout the euro area and could undermine the future of the common currency. The monetary union therefore must now be complemented by a budgetary union with fiscal transfers in which adjustment is led by countries with a surplus.

EU countries that were part of the euro area had thought that membership of the currency bloc could provide them with protection when they were hit by the financial crisis. However, even though the euro is the second most



important international currency, the speculation that developed against it at the time of the Greek debt crisis demonstrated that it too is vulnerable to the vagaries of private financial markets. European countries should therefore lend their full support to proposals for moving towards a new international monetary system, based on a truly international reserve currency and in which private financial capital flows are strictly controlled.

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# Diverging paths in development: Brazil and Mexico

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\* We wish to thank Carlos Alonso Barbosa, Marcia Leite and Fred Rosen for their fruitful comments.

The crisis that swept through the world's economies in 2008–09 hit Latin America with unexpected force. The weighted average of the region's gross domestic product (GDP) fell by 1.9 per cent, while GDP per capita plummeted 3 per cent. One of the countries hit hardest was Mexico, where the GDP shrank by 6.5 per cent in 2009, and GDP per capita by 7.5 per cent. In contrast, the Brazilian GDP rate of growth was –0.2 per cent, and GDP per capita fell by 1.1 per cent (CEPAL, 2010a). At the same time, average monthly wages in Brazil grew by 3.2 and 3.4 per cent in 2008 and 2009, respectively, while in Mexico they fell by 2.5 and 5.0 per cent (ILO, 2010). A question arises: what accounts for the different performances of two economies that had until the last decade followed a relatively parallel growth path?

To answer this puzzling question, we will show that, after a certain parallelism in macroeconomic performance during the 1990s, these economies took to different paths after 2004. The main reasons for this can be traced to the policy options implemented in each country, which resulted in different employment and incomes outcomes. This was most evident during the 2008–09 financial crisis, a period in which heterodox recovery policies – Keynesian policies with a developmental twist – were pursued in Brazil, while Mexico continued a conservative policy option.

We will first examine the macroeconomic performance of both countries, paying special attention to the institutional features which showed diverging visions of development that help to explain their performances. Then we will turn our attention to the evolution of employment and labour incomes, whose outcomes derive from the specific economic policies implemented in each country. Finally, we offer some reflections on the possible growth paths of both countries, emphasizing the social challenges they face.

Comparative studies are not very common, despite their importance for occupation and employment by contrasting and revealing the similarities and differences between different national realities. In their classic paper on international comparisons of income inequalities, Gottschalk and Smeeding argue that “international comparisons of income distribution can provide important benchmarks of how one nation differs from or is similar to other nations. In so doing, they can provide useful information, just as do cross-national comparisons of rates of economic growth, savings, inflation, and unemployment” (1997, p. 633).

A comparison of two similar phenomena in different countries allows economic processes to be put into a context that sheds light on the specific way in which the economy operates in each country, highlighting aspects of a historical and institutional character. As Hantrais and Mangen (1996) stress, it is important that comparisons be made between countries with similar levels of development. They also point to the need to make an effort to guarantee that the quantitative comparison instruments have similar characteristics. An interesting example of the application of these methodological

principles can be found in Blau and Kahn (2002), who examine the comparative performance of the labour market in the United States and OECD countries. The role of those comparisons in the analysis of the wage structure and institutions that interact in the American labour market is central to the analysis. There do exist a few comparative studies on employment or income between Brazil and Mexico, but they refer to very specific characteristics (Salas and Leite, 2007; Zepeda et al., 2007; Leite and Salas, 2009) or their analysis does not go beyond the early 2000s (Berg et al., 2006), and none discusses the institutional aspects of the economic policies enacted in both countries.

The study presented here aims to understand the consequences for labour of specific economic policies. This is a relevant undertaking, not only because it examines the largest Latin American economies (whose combined GDP accounts for 56 per cent of GDP in the region), but also because of their similar economic structures, yet different ways in which they were integrated into the globalization process. Mexico is a much more open economy than Brazil, and has as a major peculiarity its deep links with the United States as a North American Free Trade Agreement (NAFTA) member.

Over the last two decades, both countries have experienced slow and unstable economic growth. During the 1990s, neoliberal governments acted in both countries to introduce both privatization and more open trade processes. The productive structures of both countries are the most diversified in Latin America, and a significant share of production is directed to the domestic market, although foreign markets are of greater importance to the Mexican economy than to the Brazilian (28 and 14 per cent of GDP, respectively, in 2008).

Nevertheless, there remain traditional differences between the two countries in terms of their economic and social structure. Mexico still has a large peasantry and most urban jobs are associated with very small economic units (for an analysis of very small economic units in Brazil, see dos Santos, 2006). There was also a shift in Mexico's traditional manufacturing jobs towards low-skill jobs in the maquiladora plants.<sup>1</sup> Brazil, on the other hand, has a more diversified production structure, with a larger share of capital goods in manufacturing, and a significant agribusiness sector.

While such differences cannot be disregarded, up to the early 2000s similarities between the two major Latin American economies were striking. Comparisons between the two countries are extremely interesting and useful in elucidating the impact of economic policies on the characteristics of their labour markets.

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1. Maquiladora plants operate under the Harmonized Tariff Schedule of the United States (HTS rule 9802), which allows Mexican companies to temporarily export goods manufactured there and to re-import them as finished or semi-finished products, paying just one customs tax based on the value added overseas.

It might be argued that since both Mexico and Brazil maintained high interest rate policies well into the 2000s due to the external constraints, and both applied a conservative monetary policy to control inflation, the economic policies of both countries were quite similar. The main differences lay in the redistributive policies and in a more proactive industrial policy in Brazil. But that is only a part of the whole story. Other significant similarities include a concern for domestic market growth, using the stimulus of state banks; a pro-growth strategy (named the PAC Programme) to accelerate growth, which also seeks to diminish regional development gaps; and a major housing programme (*Minha casa, minha vida* – My home, my life) which has injected resources for the construction of hundreds of thousands of new dwellings and had an important impact on many industries, in addition to the construction activities. Use of state resources to stimulate the economy is a common feature of all these policies.

They resulted in the growth of good jobs, a rise in purchasing power for the population as a whole, a sharp and constant drop in unemployment and poverty, and economic growth that allowed poor segments of the population to rise to the level of middle class.

On the other hand, Mexico maintained an economic policy strongly dependent on exports, and exports to the United States in particular, accounting for 80 per cent of total exports. The main problem with this strategy is the glaring lack of backward linkages of the export activities with the rest of the economy and the subsequent dependence on imports to sustain the export process.

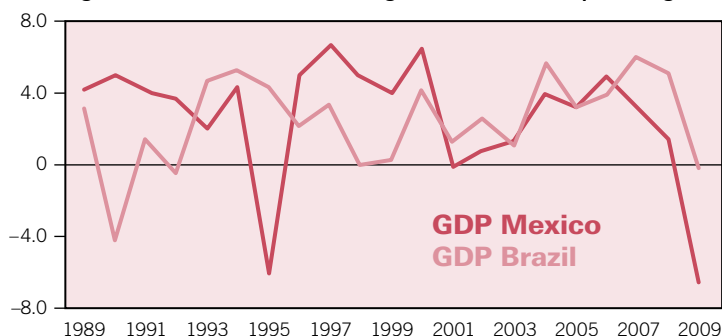
The relevant fact is that in the course of the past eight years the development paths of the two countries grew apart rapidly, to the extent that in the aftermath of the global financial crisis the economic outcomes as well as labour conditions and their current development perspectives are completely different between the two.

## Macroeconomic evolution

### Brazil since 1990

Let us begin by examining the evolution of Brazil's GDP since 1989. As figure 1 shows, the 1990s were a particularly unstable period, culminating in a recession at the end of that decade. This period was characterized by a trade liberalization process that began during the Collor administration (1990–1992), and then by a strict adherence to the so-called “Washington Consensus”, under President Cardoso (1994–2002). Privatizations, financial transparency, state retreat from regulation of the economy, control of labour costs, a pervasive effort to diminish union power, welfare reform and strict fiscal adjustments were applied after 1994 (Carneiro, 2002).

Figure 1. Brazil and Mexico: GDP growth 1989–2009 (percentages)



Source: World Development Indicators (WDI) data bank.

Access to external credit had almost come to a complete halt by the end of the 1980s and inflation was rampant. The subsequent return of external credit allowed the Government to implement an inflation control programme in 1994, when President Cardoso was elected. But liberalization with an overvalued exchange rate produced serious negative effects on employment in industry and the rise of imported goods broke down many domestic production linkages in supply chains. Financial transparency and promises of convergence of domestic and foreign interests did not meet expectations (Mattoso, 2010).

On the other hand, the persistent use of exchange-rate appreciation to control inflation soon resulted in the elimination of trade surpluses. Policy-makers used high interest rates to attract capital from abroad to finance external accounts. And even during the privatization process, preference was given to foreign groups, with the objective of attracting foreign investment. The practice of raising interest rates overloaded public finances. Public debt as a percentage of GDP was at 43.9 per cent in 1994, decreased with the stabilization of inflation to 29.5 per cent the following year, and from then increased again to reach 55.5 per cent of GDP in 2002 at the end of the Cardoso mandate. It was by now clear that high interest rates were the cause of this increased indebtedness (Barbosa de Oliveira, forthcoming). By the time of President Lula’s election in 2002, the Brazilian economy was in turmoil. The real (BRL) was overvalued, inflation was on the rise, and public debt had reached peak levels (Carneiro, 2006). As pointed out, President Lula came into power with a “cursed legacy”.

In 2003, amid financial market turbulence, the new government sought to restore calm and promoted higher interest rates and large fiscal surpluses which induced lower growth. The BRL was devalued as a result of capital flight, but a dynamic world market for commodities stimulated exports, allowing for higher GDP rates of growth. It should be stressed that although primary goods or primary-based manufacturing goods comprise 58 per cent of Brazilian exports, they are highly diversified in terms of products and

export markets. China is the only country market which accounts for more than 10 per cent of total Brazilian exports.

As Barbosa and Pereira de Souza (2010) have pointed out, the Lula administration gradually broke with the neoliberal world order of the 1990s, creating conditions for a new development strategy. Some of its features are described next.

In finance, the Government capitalized federal banks with emphasis on the Brazilian Development Bank (BNDES), which provides long-term credit for investment in manufacturing and infrastructure, and whose operations amounted to US\$100 billion in 2010. Bank of Brazil developed partnerships with national banks and other financial agents, increasing its presence abroad; in the near future, it is expected to become a major financial holding company. Caixa Economica Federal Bank (CEF) expanded housing credit and is largely responsible for boosting the construction industry. By means of fiscal subsidies, the Caixa also led a plan to build two million houses for low-income families. The Government also implemented measures to stimulate the creation of a capital market capable of offering long-term investment credit, which currently depends exclusively on the BNDES and on foreign capital markets.

Since Brazil is richly endowed with natural resources (good agricultural land and minerals), it has taken advantage of increasing prices and a growing global demand for commodities, particularly arising from the emergence of China as a major purchaser. The recent discovery of large oil fields in deep waters off the coast (the so-called pre-salt wells) strengthens the country's export capacity, removing external constraints, an important condition for continued economic growth. After the existence of such reserves was made public, the Government was prompted to modify current regulatory frameworks and established a company to control the pace of exploration in accordance with national objectives. At the same time, a special tax on oil extraction was introduced to establish a Sovereign Fund to provide financial resources for social policies and technological research projects. During the Lula administration, sizable investments by Petrobras (the national oil company, majority-owned by the Brazilian Government), stimulated the growth of industrial sectors such as refining and petrochemicals, shipbuilding and offshore oil exploration machinery. The Petrobras demand and purchase of Brazilian products works as a kind of industrial policy, by supporting the construction or reconstruction of supply chains linked to its core business. As part of an overall growth strategy, the Government strove to replicate these policies in other industries, namely in agribusiness, pulp and paper, and mining (Barbosa de Oliveira, forthcoming).

One important policy to be highlighted during the Lula mandate is the steady rise in the minimum wage, which has grown 53.7 per cent in real terms since 2003. This increase had an impact on the entire economy, not only because a large share of workers (25 per cent) earns less than the minimum wage,



but also because it is used as a marker for social security benefits payments (such as pensions). Growth of consumption has been stimulated as a result.

The 2008 financial crisis erupted in Brazil under the guise of a credit crunch. Had policy-makers followed standard orthodox practice, the economy would have entered into deep depression. The Government acted swiftly, first by maintaining the level of general government spending and of federal transfers to states. For several economic sectors (automobiles and household appliances, for example), taxes were reduced to stimulate consumption. At the same time, the Government instructed state-owned banks to expand their lending operations, thereby avoiding bankruptcies (CEPAL, 2010b). As a result of these anti-crisis policy measures, negative growth rates registered in the first two quarters of 2009 were followed by positive rates by the end of the year. A growth rate of 7.5 per cent is estimated for 2010.

During President Lula's first term of office (2003–2006), macroeconomic policy was guided by extreme conservatism. The economic context was one of high public debt, external vulnerability and rising inflation. But by 2005, the Government was in a better position vis-à-vis the financial markets, inflation was under control, external conditions had improved markedly, and the ratio of public debt to GDP had begun to decrease.

Improving economic conditions and the need for popular support to win the coming elections helped the Government to move forward toward more progressive policies. In this context, the Government reached an agreement with trade unions on a policy of minimum wage growth, extended the pro-poor *Bolsa Família* programme, and initiated a set of policies to promote expansion of infrastructure, industrial and regional development under what became known as the Growth Acceleration Programme (PAC). Dilma Rousseff, then Chief of Staff and current Brazilian President, headed this national programme.

With an improved external position, debt repayments to the International Monetary Fund (IMF) and the progressive improvement of fiscal conditions, the PAC was financed by lower primary fiscal surpluses. Thus, the conservative macroeconomic policy became increasingly restricted to Central Bank decisions alone, i.e. monetary policy and its impact on the exchange-rate appreciation. Since 2007, economic growth rates have risen substantially as a result of the impact of increased incomes and access to credit for the poorest families and the lower middle class, whose income increased through the impact of *Bolsa Família*; a rising minimum wage; the recovery of real wages through collective bargaining; increased employment; and the slow decline of real interest rates. But growth was also strongly driven by increased spending and public investment; by the PAC; and by the significant increase in private investment. Thus, progressively from the first to the second term of the Lula administration, macroeconomic policy became increasingly less conservative and involved public policy promotion of development. It is within this perspective of political change and a better external

and fiscal situation that the decisive importance of public policy measures introduced to combat the 2008 global crisis can be understood. They were implemented by a Keynesian economic team that had a clear developmental vision, in spite of a continuing conservative monetary policy.

## Mexico since 1982

In the case of Mexico, the domestic market-oriented structure that had been in place since the 1910–1921 Revolution was gradually dismantled under the De la Madrid administration (1982–1988) following the 1982 debt crisis. To manage this crisis, direct state participation in economic activities was reduced. Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986, and the sudden opening up to international trade along with lower social expenditure resulted in a sharp drop in GDP per capita and major price hikes (Barkin, 1990). These economic hardships were exacerbated by a major earthquake which struck Mexico City in 1985. Recovery measures, reconstruction of parts of the city and the initial paralysis of the federal Government at the time allowed civil society groups to flourish.

The Salinas administration (1988–1994) pushed the new export-oriented model forward at full speed. The new strategy called for minimalist state participation, privatization, deregulation and the abandonment of income redistribution mechanisms that had been built during the 1930s (Salas, 2010). As growth recovered and inflation wound down, the new strategy and the signing of the North American Free Trade Agreement (NAFTA) in 1993 were hailed as the mechanisms that would allow Mexico to join the select group of privileged First World countries (Aspe Armella, 1993). But a dramatic succession of events resulted in a downturn by the end of 1994: the Zapatista rebellion, assassinations of prominent politicians (including a presidential candidate), and a new peso crisis (Blecker, 1996). The impact of this crisis revealed the instability of the Mexican economy (Haber et al., 2008; Blecker, 2010).

The period from 1996 to 2000 was marked by repercussions of the 1995 crisis (see figure 1). Despite the severity of the crisis, GDP quickly recovered its historic growth trajectory and was accompanied by large foreign direct investment (FDI) flows and increased exports. In 2000, after ruling the country for more than 70 years, the Partido Revolucionario Institucional (PRI) lost power to a right-wing party, Partido Acción Nacional (PAN), winner of the presidential election.

A restrictive monetary policy allowed for a steadily falling rate of inflation – from an annual variation of 8.96 per cent in 2000 to 4.05 per cent in 2006. The negative impact of the economic policies of neoliberal inspiration is evidenced by a virtually stagnant situation prevailing in the present decade, particularly in relation to GDP per capita (Salas, 2010). Nevertheless,

it should be observed that during the six years of the Fox mandate (2000–2006), GDP per capita grew at an annual rate of only 1.0 per cent compared to 1.4 per cent during the previous administration.

The real impact of exports during recent years has to be analysed carefully. First, the effects of exports are diminished by the concomitant rise in imports, as shown in Scott, Salas and Campbell (2006). This dependency on foreign products for internal production did not change under the neo-liberal regimes, and represents one of the major sources of vulnerability of the Mexican economy, as witnessed during the 2008–2009 crisis (see also Fernández, 2010).

Second, data from the maquiladora industry stands out in the calculations of total exports. In a strict accounting sense, the activities of maquilas constitute neither a true export nor an import because there is no currency entering or leaving the country except the amount of the value added produced in Mexico, which results by definition in a positive trade balance for the maquiladoras. In 2006, the Mexican Government changed the way in which these activities are reported in national economic statistics, so their performance during the crisis cannot be asserted. Nonetheless, for pre-2006 data, the fact that Mexican foreign trade statistics included maquiladora plants resulted in a 75 per cent average overestimation of Mexican export performance.

In terms of manufactured exports, the most important category is that of automotive products, which in 2005 represented 40 per cent of the total non-maquiladora exports. This sector produced the highest absolute growth between 2001 and 2005, but has a weak multiplier effect in terms of job creation. As a result of economic integration with the United States, Mexican exports in particular are strongly dependent on US economic performance, a fact that became abundantly clear during the 2008–2009 crisis and will mark the evolution of the Mexican economy for many years to come.

Despite the increase in non-petroleum exports, the volume of Mexican exports in US foreign trade has diminished progressively due to the successful performance of Chinese products. For many years, Canada has been the main trading partner of the United States, with Mexico in second place from 2001 to 2003, when Chinese exports to the United States surpassed Mexican exports. By the third quarter of 2006, total exports from China were 38 per cent higher than Mexican exports. Chinese trade policies, based on a well-structured industrial policy, stand in stark contrast to the Mexican development path, which had to resort to trade agreements to guarantee access to the US market (Gallagher, Moreno and Porsekansky, 2008).

Due to increases in petroleum prices, foreign sales of this product went from representing 16 per cent of exports in 2001 to 27 per cent in 2005. It is important to note the waste of the windfall produced by high petroleum prices in recent years. It is estimated that between 2001 and 2008, approximately US\$130 billion entered the country via petroleum income. Only a

very small portion of this sum went towards increasing investment; the majority of the funds went towards government spending, particularly towards payments associated with the bailout of banks that had crashed during the 1995 crisis.

Before the crisis in the United States, the current account had performed better than the trade balance, due largely to tourism – which accounts for 8 per cent of GDP – and the remittances from Mexicans living in the United States. The total amount of remittances increased every year, in particular during the past decade. From 2003 to 2006, this amount rose from US\$15 billion to US\$26 billion, but the flow diminished visibly after 2008 and has not recovered to pre-crisis levels, as 2010 data stand at US\$21 billion. In fact, Mexico holds second place in the world in terms of foreign remittances, with India in first place.

After 1994, FDI – a significant portion of which has been directed towards the purchase of existing assets – accounted for most of Mexico's net financial inflows (Blecker, 2003). The majority of FDI is composed of “new investment” funds that have been used mostly for the purchase of existing companies. These “new investments” have followed an irregular pattern. In contrast, the investments in maquiladora and the flow of accounts between firms have grown in a sustained manner. The problem with both types of flow is that they correspond to account balances between firms that do not translate into real technology transfers, nor necessarily into job creation. Additionally, the flow of FDI toward industrial activities has diminished since 1980 and has been directed increasingly toward services. In 1980, 80 per cent of FDI went toward manufacturing, while in 2006 this percentage had fallen to 50 per cent. Therefore, the notion that general growth is driven by FDI and exports appears to be more of an overstatement than a reality. Also, the only benefits resulting from maquiladora activity are the direct wages and salaries it pays, because it uses relatively few inputs from other Mexican firms or industries. On the other hand, the flow of FDI toward services rarely results in technology transfer – as has already been shown, it translates into the acquisition of existing firms as part of foreign firms' consolidation or introduction into the Mexican market.

If the push to attract more FDI was intended to trigger a higher rate of capital accumulation (Berg, Ernst and Auer, 2006), the increase in FDI flows failed to work as expected in Mexico. As Blecker (2009) puts it:

Mexico's various policies of opening and liberalization have made the country's growth highly vulnerable to certain external constraints or “shocks” since the late 1970s. Our econometric results show that Mexican growth has been tightly constrained by three key “external” variables: net financial inflows, defined as the sum of current transfers plus the financial account balance (excluding official reserve transactions) in the balance of payments; the world real price of oil; and the growth rate of the US economy.

In addition, Mexico's export orientation and import liberalization have made the country's growth very sensitive to the real value of the peso, taken as a measure of external competitiveness ... Perhaps surprisingly, we are unable to confirm statistically significant effects of either FDI or public investment on total investment spending during our sample period. [emphasis added]

When the crisis erupted in late 2007, the Mexican Government minimized the dangers for the economy, and it was only at the beginning of 2009 that any anti-crisis policies were announced. Most of them were additions to the approved federal budget, such as investments in infrastructure, employment-related policies such as support for companies in difficulty to maintain jobs, and other measures to improve the reach of the existing temporary employment programme (CEPAL, 2010b). In principle, these measures should have helped to stimulate economic activity, preserve jobs and create income for vulnerable groups. Nevertheless, during 2009 GDP shrank 6.5 per cent, unemployment rose to 6.3 per cent in August, average wages plunged 4 per cent and most of the net job creation came from very small economic units. So it is not surprising to find that, according to the Federal Treasury Accounts, even if the approved 2009 federal budget was 13.7 per cent higher in real terms than the one originally approved in 2008, the amount actually spent fell 6.5 per cent compared to the previous year. In 2010, the total federal budget was cut by 1.6 per cent in relation to 2009, and so the figure was -10.3 per cent below the amount spent in 2008 – not exactly a very robust policy approach to overcoming a crisis!

Mexico's presence in global markets after its adhesion to NAFTA gave a strong impetus to domestic manufacturing activities. This was briefly interrupted by the 1995 crisis, but later resumed by means of a massive devaluation of the currency and a steady inflow of foreign investment, resulting in a recovery period that lasted to the year 2000. Since that year, unstable growth has been the rule. Although inequality and poverty tended to decrease after 2000, by 2006 this process had slowed (Salas, 2010; Moreno-Brid and Ros, 2009), and poverty remains high (Zepeda et al., 2009). As the latter show, contrary to the expectations of orthodox policy, trade liberalization has not improved the economic performance of Mexico; neither has it created better jobs or improved income levels. Opening the economy did increase trade and foreign investment, but demand for exports did not fuel growth, as maquiladora activities are detached from the Mexican economy (save for the wages they pay), and the non-maquiladora activities are concentrated in sectors that have few demand linkages with the rest of the economy, as is the case of the auto parts industry (Villegas, 2010).

## Labour market outcomes

### Mexico

In terms of job creation, as the export-oriented model evolved a slowdown in the manufacturing sector reduced capacity to generate new jobs; the pace of waged jobs creation slowed; and increases in small-scale economic activity and a rapid increase in job outsourcing occurred. Some of these characteristics, as well as increasing the percentage of employees with neither labour rights nor access to social security (Salas and Zepeda, 2003), are the living face of job insecurity.

As shown in table 1, Mexico is characterized by very low rates of open unemployment, compared with countries of the same size or income levels. Even during crisis periods (1995 and 2009), overall unemployment rates never exceeded 7 per cent. Open unemployment in Mexico is measured using international standards: including people who have not worked for even an hour during the past week and have undertaken a labour search process. The enigma can be explained, as argued in Salas (2010), by the presence of a large self-employed group and by significant international migration, lack of unemployment insurance – save for Mexico City – as well as by the fact that the share of wage labour in total employment reached levels similar to those of other industrialized countries only in the late 1980s, so that the lack of occupational opportunities is expressed in the form of very small-scale activities rather than as open unemployment. Living in open unemployment conditions is a “luxury” few can afford (Udall and Sinclair, 1982). In fact, average unemployment duration is less than four weeks, and only 35 per cent of the unemployed are household heads.

After the 1995 crisis, wages recovered to pre-crisis levels in 2000 and then grew slowly until 2008, when they started to fall again, even before the crisis in Mexico was full-fledged (table 2). Manufacturing wages remained low and fell further behind those in the United States (Zepeda et al., 2009), contrary to a wage convergence process predicted by the mainstream economists (World Bank, 2003).

Income distribution was unstable, as shown in table 3, which prompted analysts to talk about a declining inequality. However, it is highly improbable

**Table 1. Mexico: Employment and unemployment, 2001–09**

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Economically active population (thousands)	39061	40085	40417	42100	42274	43575	44411	45460	45709
Employed	38065	38940	39222	40561	40792	42198	42909	43867	43344
Unemployed	996	1145	1195	1539	1482	1377	1502	1593	2365
Unemployment rate (percentage)	2.5	2.9	3.0	3.7	3.5	3.2	3.4	3.5	5.2

Source: Authors' calculations from National Employment Surveys.

**Table 2. Mexico: Average monthly income, wage workers 14 years old or more, by sex, 1995–2009 (second quarter of each year in constant 2002 pesos)**

Année	1995	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total	3514	3556	3624	3699	3733	3711	3825	3925	3821	3671
Men	3790	3799	3863	3922	3969	3951	4057	4194	4092	3873
Women	2947	3098	3174	3272	3296	3300	3426	3470	3362	3326

Source: Authors' calculations from National Employment Surveys.

**Table 3. Mexico: Gini coefficient, 1994–2008**

1994	1996	1998	2000	2002	2004	2006	2008
51.9	48.5	49.0	51.9	49.7	46.1	48.1	51.6

Source: WDI data bank.

that inequality will diminish steadily in the near future, given current economic policies and the ensuing poor growth record of the Mexican economy in recent decades.

As shown, employment conditions in Mexico were already not very promising and may now become even worse through the effect of the current crisis on the economy.

## Brazil

The Brazilian employment outlook during the 1990s was very bleak. Opening to trade and privatization, together with the general macroeconomic conditions, resulted in social regression. Unemployment rates grew steadily, the numbers of workers with *carteira de trabalho* (job cards) – which meant they were protected by social and labour laws – dropped, wages went down after 1995, inequality was high and poverty rampant (Pochmann, 2008). By the end of the decade, 1,400,000 jobs had been lost in the manufacturing sector. After the 1999 crisis and subsequent devaluation, manufacturing activities recovered steadily. But it was only after 2003 that labour market trends began a major change.

**Table 4. Brazil: Employment and unemployment, 2001–09**

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Economically active population (thousands)	84018	86963	88774	92660	95748	96874	97872	99500	101110
Employed	76163	79008	80147	84419	86840	88725	89898	92394	92689
Unemployed	7855	7955	8627	8241	8908	8149	7974	7106	8421
Unemployment rate (percentage)	9.3	9.1	9.7	8.9	9.3	8.4	8.1	7.1	8.3

Source: Pesquisa Nacional por Amostra de Domicílio (PNAD), Instituto Brasileiro de Geografia e Estatística (IBGE).

The increase in the average growth rate of GDP over the period 2004–08 (figure 1) translated into significant positive impacts on the Brazilian labour market. Not only did unemployment decrease, but there were also improvements and important qualitative changes in the occupational structure: the relative importance of wage labour without job cards (unregulated labour), self-employment and unpaid work declined (de Andrade Baltar et al., 2010).

A positive trend had begun after GDP stagnation for over a quarter of a century, along with the economic liberalization of the 1990s and the abandonment of any traces of policies aimed to promote economic development. This was clearly visible in the evolution of real wages (table 5); at the same time a systematic rise in the minimum wage was implemented, as already pointed out. But in 2010 real wages had still not regained their 2002 levels.

As a consequence of this and other social policies (de Andrade Baltar et al., 2010), poverty was reduced from 55 million people in 2005 to 39 million in 2009, and the domestic market flourished.

**Table 5. Brazil: Labour income, 2002–10 (June, in constant reais)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Employees	1352	1227	1252	1225	1278	1283	1273	1321	1348
Self-employed	1187	949	930	936	960	1047	1095	1140	1169

Source: Pesquisa Mensal de Emprego (PME), Instituto Brasileiro de Geografia e Estatística (IBGE).

## Conclusions

As we have shown, during the 1990s economic policies in both Brazil and Mexico followed the standard Washington Consensus prescriptions, although Mexico had already begun open trade and privatization processes in the mid-1980s. Despite political attempts to move away from those policies, the left of the political spectrum was never able to come into power. In effect, NAFTA rules locked Mexico into a path of “low road” development, and in 2000, after 70 years of PRI rule, Mexicans elected a right-wing populist PAN (National Action Party) candidate as President. After a disputed election in 2006, PAN retained the Presidency, maintaining conservative policies not only in the economic sphere (Moreno-Brid, Pardinas and Ros, 2009) but also with regard to many social issues. The lack of an articulated national social movement stands as a major roadblock to progressive government change in the near future (Almeyra, 2008).

In the case of Brazil, the struggle against the military dictatorship, in particular that led by union movements and other social actors (Sader, 1988; Jacobi and Nunes, 1982; Telles, 1988; Caccia Bava, 1988; Dagnino, 1994; Gohn, 2010) resulted in a strong nationwide popular movement that arrived on the national political scene in 1981 with the founding of the Partido dos Trabalhadores (PT). Social movements were able to help Brazil return to a democratic government and a new progressive constitution was



approved in 1988 (Biavaschi, Krein and Santana, 2010). In 1990 the ruling classes returned, electing a free-trader as President (President Collor, who was impeached two years later for corruption). An interregnum of two years followed, after which President Cardoso was elected. A neoliberal policy path was pursued, but strong social movements, social resistance to privatization processes and new electoral strategies allowed the PT to come to power in 2003. As a latecomer to neoliberalism, Brazil was able to escape the standard locked-in trajectory that was characteristic of Mexico's context after 1982.

Brazilian economic and social performance shows that a high road to development can be achieved by a mixture of state participation in the economy, social policies to improve wages, monitoring of labour rights and labour law enforcement (de Andrade Baltar et al., 2010). Much remains to be done to secure an inclusive development strategy, but the initial steps have been taken.

In contrast, Mexican economic performance demonstrates that when government allows unfettered private-sector participation in the economy, leaves finance in private hands and has no investment policies whatsoever, then low growth rates will prevail, and poverty and labour market hardships will continue to be part of daily life. The 2009 assault on the Electric Workers Union (*Luz y Fuerza*) was just one action in an overall offensive against social movements, inasmuch as that particular union had been a staunch supporter of social protests against neoliberal policies.

On the whole, the macroeconomic and labour market results outlined above show the consequences of Mexico's greater integration into the North American market, as well as the results of an export model that ignores the domestic market and whose benefits are concentrated in just a few hands.

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# Making an unstable financial system work

*Reform options*

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Following the crisis of the regulated type of capitalism in the tradition of the New Deal, a radical market globalization project was established in the 1980s. Its cornerstone proposed the deregulation of both financial and labour markets, and included a definite bias against trade unions. By the late 2000s, this system had become so unstable that the world economy came to the brink of collapse; only massive monetary and fiscal interventions prevented an economic depression comparable to that of the 1930s. In this contribution, we will analyse the nature of the instability of the current financial system and review possible reform options. Clearly, this is but one of the areas in which reforms are needed to establish a new version of a regulated type of capitalism.<sup>1</sup>

### Financial market instability

There are two main interwoven features which have characterized the development of the financial system over the past 30 years. First, the deregulation of international capital flows and the resulting deep integration of international financial markets. Huge increases in international capital flows and the switch to flexible exchange rates after the final breakdown of the Bretton Woods System in 1973 created a new source of shocks and uncertainty, and new scope for speculation. A second feature is the increasing importance of non-bank financial institutions such as investment funds, hedge funds, private equity funds which have come to dominate the financial systems of most developed countries. In some countries, notably the United States, the financial disaster of the 1930s led to the separation of the commercial and investment banking functions. But after the start of the liberalization period in the 1970s, this separation was increasingly eliminated. In other countries, in continental Europe for example, universal banking which had always been allowed but was completely unimportant in the 1950s and 1960s, gained in significance from the 1980s onwards. Finally, once-sheltered segments of financial markets, such as real estate sector financing, became fully integrated in national and international financial markets.

### The shadow financial system

The increasing importance of investment banking went along with a fundamental change in the functioning and the motives of the agents in the financial system. Throughout the deregulation period a so-called shadow financial system with little or no regulation gained ground. Regulation arbitrage added

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1. For a comprehensive vision of regulated capitalism, See Dullien, Herr and Kellermann (2011) and Herr and Kazandziska (2011). See these sources also for detailed empirical developments which cannot be presented in this paper.

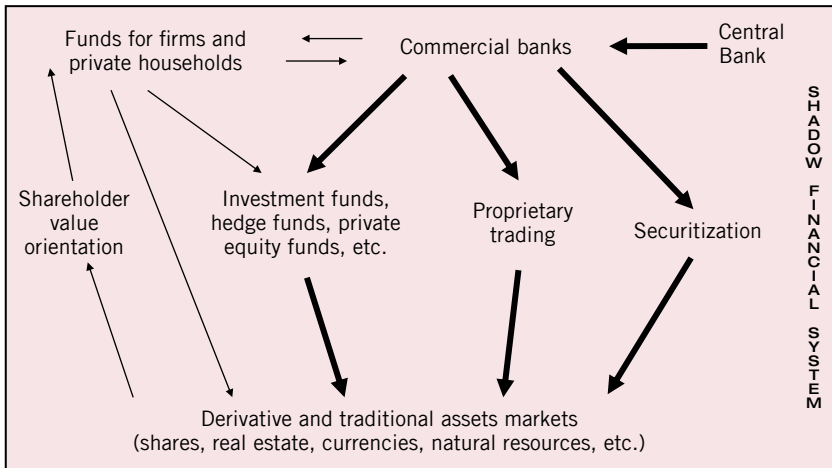
to the explosion of this sector. Most non-bank financial institutions are located in this shadow financial system. Part of the shadow financial system is located in offshore centres with minimal regulations which facilitate tax evasion, money laundering and other internationally organized criminal activities. Institutions in the shadow financial system usually have a speculative orientation, seek high short-term returns, are much more risk-oriented and often work with extreme leverages. The changing culture of finance also modified the activities of commercial banks which adjusted to the behaviour of the institutions in the shadow financial system. Increasing competition in the financial system added to the risk-prone behaviour of financial institutions. Last but not least, changes in the financial system led to a new corporate governance system. Stakeholder capitalism with a corporate governance system that sought compromise between the interests of owners, workers and unions respectively, debtors and sometimes the local community was substituted by shareholder capitalism, which subordinated publicly traded companies to the interest of financial markets, enforcing higher profit mark-ups and a short-term orientation for management. Shareholder capitalism also led to an explosion in earnings for management, mostly paid in the form of bonuses based on the current situation of companies.

The structure of the current financial system is given in figure 1. As a rule, central banks interact only with commercial banks and in this way create money. In the modern financial system, central banks can create money ad hoc or, as Schumpeter (1951) expressed it, “out of nothing”. This capacity of the central bank is vital to the stability of financial systems because the central bank is a lender of last resort, whose role is to guarantee the liquidity of the financial system and of the whole economy. The need for, and ability of, central banks to act as lender of last resort was shown in an exemplary way during the subprime crisis of 2007. Traditionally, commercial banks used the money they received from central banks to provide credit to firms and households whereby the latter would keep most of their monetary wealth as deposits with commercial banks. In the Anglo-Saxon financial systems, households (including pension funds) would keep a higher percentage of their wealth in investment funds or own equity themselves, but holdings would mainly be long-term oriented. These traditional models broke down and gave way to the current financial system.

### Links between commercial banks and the shadow financial system

One of the features of the new system is that there is a direct relationship between money creation by the central bank, commercial banks and the high-risk shadow financial system. There exist three main channels of transmission between commercial banks and the shadow financial system. These are illustrated in figure 1 (in bold arrows).

**Figure 1. Main features of the neoliberal financial system**



Through securitization, the first channel, liabilities take the form of tradable assets and can be traded in secondary markets. For example, for a long time governments issued debt securities which were bought by the public and could be traded in the capital market. A relatively new type of securitization takes the form of banks selling their credit portfolios to non-bank financial institutions in the shadow financial system. This was the case with mortgages in the United States before the outbreak of the subprime crisis. In the last decade, banks began to grant prime loans not only to good debtors but they also substantially increased subprime loans to debtors with a relatively high probability of default (debtors with no, or low, collateral and/or low and unstable income). The main innovation which made possible the mass sale of subprime credits was the so-called “waterfall principle”, whereby loans were pooled and subdivided into separate tranches, typically known as the “first loss” piece, the mezzanine tranche and the senior tranche. If the most vulnerable borrowers could not service their debt only the first loss piece was affected, and those who held it had to bear the entire loss. Next came the mezzanine tranche, and only when these two were completely exhausted by losses were the purchasers of senior tranches affected. Senior tranches, therefore, seemed secure, even in the case of subprime loans. The different tranches were issued as mortgage-backed securities or collateralized debt obligations; the buyers of the first loss piece incurred the highest interest rates, the ones in the senior tranche the lowest. Such papers could be pooled and cut several times and mixed with other types of loans, for example credit card loans or credit to emerging countries.

The sale of their loans allowed banks to engage in much higher credit expansion than would otherwise have been possible. However, there was a moral hazard involved in this as banks did not have to concern themselves



so much with the quality of loans since the risks were sold to someone else and were presumably diversified to investors over the world. Nevertheless, in many cases, banks provided guarantees for, or owned, institutions pooling and selling securitized loans in the shadow financial system and were therefore also affected when these institutions broke down, as became clear after the outbreak of the crisis. These structured products became so complicated that even experts were hardly able to understand them. Rating agencies, a cartel of three private firms without a legally binding mandate or government supervision, evaluated the papers, while at the same time often providing advice on how to design such credit derivatives.

The second channel between commercial banks and the shadow financial system consists of proprietary trading whereby commercial banks are involved in all types of speculative and risky activities, financing themselves via the central bank and government-guaranteed bank deposits. Huge financial institutions also developed, conducting their business in all segments of the financial system.

The third channel is the credit granted by commercial banks to non-bank financial institutions. This allows the latter to engage in very risky, and at the same time extremely leveraged, activities. For example, a private equity fund can borrow a huge amount in order to carry out an unfriendly takeover of a company. If this is successful, the private equity fund can pay back its credit with a profit (a) by destroying the company and selling different parts of it, including real estate, or (b) by dictating a special distribution of funds to substitute equity by debt. Alternatively, a hedge fund can take out a loan to speculate against a currency or in all types of derivative markets. Securitization, proprietary trading and credit to risk-taking non-bank financial institutions exposed commercial banks to new and excessive types of risk.

All three channels between commercial banks and the shadow financial system have contributed to a significant increase in the fragility of the financial system. All of them reduced the equity which is held in the financial system in per cent of credit given. An additional problem was that widespread securitization increased the individual estimation of liquidity; agents simply expected to sell papers any time they wanted in secondary markets. But market liquidity did not increase because individual liquidity of securitized credits disappears as soon as everyone begins to sell papers in secondary markets.

Derivative markets were developed, for example, to insure changes in interest rates or changes in exchange rates. Derivatives covering risks such as changes in weather or natural disasters also became commonplace in spite of the fact that ultimately, the pricing of such derivatives is not possible. The use of one particularly problematic type of derivative, the so-called credit default swaps (CDS), exploded in the course of the past decade.<sup>2</sup> In such a transaction,

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2. Reliable sources indicate that the CDS market had grown to a value of more than US\$60 trillion by 2007 – the equivalent of the annual global economic output (ISDA, 2010).

one party pays the other a premium for receiving an agreed sum of money in the event of a credit default. Risk-taking institutions could thus insure possible defaults in almost unlimited amounts without tapping into their own capital. This gave the illusion that default risks disappeared from the market, until it became clear that the institutions which were expected to step in to compensate for defaults could not do so (Hellwig, 2008).<sup>3</sup> Most derivatives were traded over the counter (OTC), which means they were traded bilaterally, on the basis of individually constructed contracts. Transparency in the market was completely lost. The problem with derivative markets is that they reduce the risk of one trading partner but increase the risk of the other. Risk will not disappear by trade, rather it is distributed differently. In many cases both contract partners were speculators who transformed the market into a big casino.

### Money creation and financial instability

As mentioned above, in deregulated financial systems there exist direct links between a central bank's money creation and speculative activities in asset markets. Due to institutional changes and changes in the philosophy of central banking, interest rate policy in modern financial systems became the only tool available to central banks by which to govern price level changes, asset price bubbles, exchange rate movements and GDP growth. This confronted them with different dilemmas, however. For example, stopping asset price bubbles in a situation of low GDP growth and low goods market inflation with high interest rates can push the real economy into a sharp recession, or even deflation. Or, low interest rates to fight against low GDP growth and deflationary developments can stimulate asset price bubbles. The problem behind these dilemmas is that the central bank has no control over the allocation of credit. In regulated types of financial systems central banks could be sure that at least the lion's share of credit expansion and money creation flows to the productive sector, meaning that investment flows into the real economy, excluding the real estate sector. In the deregulated financial system credit expansion and money creation can directly feed speculative activities without substantially stimulating productive activities. As a consequence of deregulation, asset price bubbles with nefarious economic outcomes have become more frequent and much more harmful: cases in point are the internet stock market bubble in the second half of the 1990s, the real estate and stock market bubble in the 2000s, which led to the outbreak of the subprime crisis in 2007, the speculative hikes in oil and food prices, etc. In parallel, liberalized and unstable international capital flows have led to exchange rate

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3. In 2008 the American International Group Inc. (AIG), one of the largest insurance companies in the world, had to be nationalized as its collapse would have meant a collapse of the world CDS-market.

volatility and increasing current account imbalances which have added to the instability of world financial markets. Monetary policy in the international sphere is also confronted with dilemmas. For example, sudden capital outflows after a prolonged period of capital inflows can force a central bank to introduce a very restrictive monetary policy in spite of low growth and high unemployment in the domestic economy.

In almost all cases, asset price bubbles have arisen with credit expansion but, in most instances, without financing productive economic activity, or only to a small degree. The general picture over the past 30 years is that the indebtedness of economic sectors increased in an extreme way (Herr and Kazandziska, 2011). For example, in the United States private household debt in per cent of GDP increased from below 50 per cent in the 1970s to over 130 per cent by the end of the 2000s. In the same period, commercial debt increased from around 75 per cent to over 125 per cent. Household debt in the United Kingdom is now over 100 per cent of GDP, with commercial debt at over 250 per cent.<sup>4</sup> Government debt to GDP in many countries has also increased sharply throughout the past decades, and particularly after 2007 when governments bailed out financial institutions.

These high debt levels make asset price deflation a very dangerous element of the deregulated type of capitalism we have today. As early as 1933, Irving Fisher had understood very clearly that the combination of credit-driven asset price bubbles led to unavoidable phases of asset price deflation, which in turn led to an explosion of non-performing loans, fire sales and the risk of collapse of the financial system, as experienced when the subprime crisis broke out. The danger is that asset price deflation turns into a goods market price deflation which would translate into an explosion of the real debt burden and therefore into even more non-performing loans. The real debt burdens in times of goods market deflation increase as nominal debt is fixed, but company turnover, wages, tax revenues, etc. decrease in nominal terms (see also Minsky, 1975; Kindleberger, 1996).<sup>5</sup> Goods market deflation becomes a serious danger when asset price bubbles lead to asset price deflations and medium-term crises with high and persistent unemployment. The latter can trigger nominal wage cuts and falling unit-labour costs. In such cases a deflationary wage–price spiral akin to that of the 1930s is likely (Herr, 2009). The case of Japan has clearly demonstrated that after an asset price bubble and the resulting stagnation, wages can start to fall and deflation follows (Herr and Kazandziska, 2010).

4. Fed Flow of Funds Accounts Database (2010); UK Office for National Statistics (2010).

5. We can express the disastrous effect of a deflation also in terms of the real interest rate (which is defined as nominal interest rate minus the percentage change of the price level and expresses the real burden of debtors). Let us say the nominal interest rate is 1 per cent and the deflation rate is 20 per cent. In this case the real interest rate becomes 21 per cent. The real debt effect of a deflation is similar to a situation in which a country is highly indebted in foreign currency and the domestic currency depreciates.

## Misleading regulation

To make matters worse, the deregulation and resulting instability of financial markets was not compensated by more rigorous supervision. Indeed, the opposite was the case. The switch from Basel I to Basel II, with both aiming to define international rules for equity holding of banks, in fact produced a fundamental shift in banking supervisory practice. Basel I, decided upon in 1988, followed the so-called standard approach via which assets had to be classified in several categories according to credit risk. The various categories of credit carried different risk weights. Required equity holding was equal to 8 per cent of the risk-weighted assets irrespective of the economic situation. For example, government bonds of OECD countries had a weight of zero and did not lead to equity holding whereas most corporate debt and credits to private households had a weight of 100 per cent and led to an equity holding of 8 per cent of the credit granted. Basel II was officially recommended by the Basel Committee on Banking Supervision in 2004, but in essence had already been implemented in 1996 in most Western countries with the Amendment to the Basel Accord. Basel II allowed banks to use their own risk models or the risk evaluations of external institutions like rating agencies as the basis for required equity holdings. Such risk models were used not only for the equity holding of banks but also for the risk evaluation of asset portfolios, complicated derivatives, etc. The switch to such risk models had two major consequences.

First, these models pretend to deliver knowledge about the future in spite of the fact that the future is uncertain and unknown. Risk evaluation in such models is based on historical data about default rates, volatility of asset prices, correlations between asset price movements and the like. The theoretical justification for such an approach rests on the hypothesis of efficient financial markets developed by Eugene Fama (1976) and, on a macro-economic level, the hypothesis of rational expectations developed by Robert Lucas (1972), both of which are based on methodology originating in physics.<sup>6</sup> Physics-based economic models are not suitable for an analysis of social processes. Yet they served as the ideological justification to make us believe that the future can be calculated and that financial markets are inherently stable. These risk models have strong pro-cyclical effects and add to asset

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6. Both approaches are based on ergodic stochastic processes which, it is argued, cannot be persistently different in the future and in the past. Logical time as in Newton's mechanics is the basis of such thinking. William Sharpe (1993, p. 2), one of the fathers of financial models, speaks about nuclear financial economics. "An important subfield of physics – Nuclear Physics – deals with smallest particles of which matter is composed. Constructs developed by Kenneth Arrow and Gerard Debreu provide similar foundations for financial economics. With a bit of hyperbole, the approach may be termed nuclear financial economics." The most popular asset pricing model, the so-called Black-Scholes-Merton-Model (Black and Scholes, 1973; Merton, 1973), is based on the Brownian motion, a model mathematically described by Albert Einstein in 1905 of seemingly random movement of particles suspended in a fluid.

market volatility and bubbles. For example, during a period of asset price inflation in the real estate market defaults occur relatively seldom, and historical data signal low default risks and a low equity holding. During a period of real estate crisis default rates become high and equity holdings jump to relatively high levels. Ratings of derivatives and financial products share the same weakness. The subprime crisis has shown that the assumption of rating models, for example stable correlations between asset prices, is fundamentally wrong and in crises existing ratings become obsolete.

Second, Basel II allowed banks to reduce equity holdings to far lower levels than was the case under Basel I and hence to increase their debt-to-equity ratio and the return on equity. Equity holding of banks such as the Deutsche Bank or the Union de Banques Suisses (UBS) dropped from about 10 per cent of their balance sheets in the early 1990s to somewhere around 2–3 per cent on the eve of the subprime crisis. Institutions in the shadow financial system had in many cases almost no equity. The financial industry lobbied hard for Basel II and, thanks to the political constellation in the 1990s, won its case despite the doubts of many financial regulators (Hellwig, 2008).

Accounting standards are set by two private institutions, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). In the 1990s, both boards pushed for fair value or mark-to-market accounting which also became the dominant accounting standard for financial institutions. In essence, this accounting standard, theoretically based on the hypothesis of efficient financial markets, holds that assets have to be booked at actual market prices and, if market prices are not available, at simulated market prices. In former times, assets in most countries had to enter the books at historical value or at market prices if market prices fell below historical values. Like Basel II, fair value accounting added to the pro-cyclical bias of asset markets: during the bubble, fair value accounting led to a swelling of the value of assets on balance sheets and thus to higher equity and higher profits. These developments led to high bonus and dividend payments which, however, did not reflect operational profits and cash flows. Higher asset prices not only led to higher bonus and dividend payments, but also further stimulated the bubble. Conversely, during periods of asset price deflation, the equity of financial institutions shrinks as falling asset prices directly lead to losses and a reduction in equity. This fuels the “fire sale” of assets and leads to a further collapse of asset prices, a credit crunch, and liquidity and solvency problems.

### Options for the reform of the financial system

The objectives of reforms must be to reduce the instability of the financial system, and to make the financial system a supporting instrument for economic development and employment, while giving society the possibility of

holding on to wealth in a safe way. Guaranteeing high returns is not a useful aim for financial systems. The key policy of reform must be to scale back the size of the shadow financial system substantially in almost all its dimensions and to change the way it functions, while at the same time leading commercial banks to return to the “boring” business of providing loans to the public.

What has happened so far? Nassim Taleb (2010) has aptly articulated the policy response to date: “You have a person who has cancer and instead of removing the cancer, you give him tranquilizers. When you give tranquilizers to a cancer patient, they feel better but the cancer gets worse.” In short, policies after the subprime crisis have not radically cut back the dangerous and useless elements of the financial system. In fact, the opposite is the case, as the system has been fed by even more credit and liquidity. I will now propose some principles to guide the essential reform of financial systems.

### Separation of commercial and investment banking

A key element of any reform must be a clear separation – in the tradition of the Glass-Steagall Act – between commercial banks and the speculative and risk-oriented non-bank financial institutions. All three arrows in figure 1 between commercial banks and the shadow financial system must be severed.

- (a) In this new configuration, proprietary trading by commercial banks would be forbidden.
- (b) Commercial banks would not be allowed to own non-bank financial institutions and vice versa. This would also help to solve another problem, that of institutions that become too big to fail.
- (c) Commercial banks would not be allowed to give credit to non-bank financial institutions. Such a regulation would mean that non-bank financial institutions would have to tap the non-bank sector, especially private households, to get funds for their activities. This would substantially reduce the leverage and the size of non-bank financial institutions. Such a system would still allow sufficient venture capital for start-ups and other risk-prone activities. Non-bank financial institutions under such a regulation could default without the danger of a systemic financial crisis and the need for government intervention.
- (d) If the originator of a loan were forced to keep a substantial part of the loan, and especially a large part of the first loss piece in its own books, this would help make securitization safer (see below). However, securitization should be limited to the extent that commercial banks should be required in their core activities to follow the traditional business model of a bank, that is, making a loan and keeping it until it is paid back.

Insurance companies are similar to commercial banks in that they collect monetary wealth from society as a whole and offer services such as organizing the payment system, insuring risks and providing safe and liquid assets for household savings. These are all public goods and must be especially protected by comprehensive supervision. The breakdown of insurance companies, for example, is harmful to many people and to society as a whole. For this reason, comprehensive supervision of insurance companies is as necessary as it is for banks. In particular, the investment behaviour of insurance companies must be regulated in such a way as to limit high-risk ventures. For pension funds, the same basic argument applies.<sup>7</sup> Insurance companies and pension funds are already required to follow certain rules. These could be tightened with respect to certain transactions, such as the types of investment permitted, or limitations placed on portfolio investment in other currency areas and especially in emerging markets.

Real estate financing, with its particular social and financial dimensions, could be considered a special case and permitted only by specialized and state-licensed institutions. The experience of the decades following the Second World War has shown that specially regulated financial markets for real estate investments added stability to asset prices while delivering sufficient and affordable housing at the same time (Cardarelli, Igan and Rebucci, 2008).

Reform steps taken after the subprime crisis have been, in part, an attempt to cut the links between commercial banks and the rest of the financial system. In July 2010, US President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (United States Senate, 2010). In the United States, proprietary trading is now limited and ownership of hedge funds by commercial banks is restricted. In Europe, (anticipated) regulations will lead to some restrictions in proprietary trading and ownership of hedge funds by commercial banks, but regulations will not go as far as those in the United States. This despite the fact that the De Larosière Report (2009), which was ordered by the European Commission to develop proposals for financial market reform, recommended a stronger delinking (Dullien and Herr, 2010).<sup>8</sup> Hence, both in the United States and

7. Capital-based pension systems are exposed to financial market turbulence and in this respect are more hazardous than pay-as-you-go systems. In any pension system the young pay for the old. It would seem to be advisable to resolve the share of payment between old and young by political means rather than to leave the distribution to anonymous market forces, which can lead to highly undesirable outcomes.

8. Europe has seen some progress in the reform of supervisory authorities. The De Larosière Report (2009) recommended stronger financial market supervision in the EU which did not exist in the past. Currently, three European authorities are responsible for the supervision of financial markets: the European Banking Authority in London, the European Securities and Markets Authority in Paris and the European Insurance and Occupational Pensions Authority in Frankfurt. In the new regulatory system, the three authorities will have the right to monitor the implementation of EU regulations. In relation to the management of

in Europe especially, current credit relationships between commercial banks and non-bank financial institutions are maintained and will continue to feed the financial ulcer.

### Control of the shadow financial system and of derivatives

Severing the links between commercial banks and non-bank financial institutions would lead the latter to shrink in size and importance, but this would not be enough. All financial institutions should be made transparent and be regulated, from hedge funds to private equity funds and traditional investment banks. Regulation would require such institutions to inform the public about their activities, keep a certain amount of equity, supervisory agencies to control the business model of such institutions, etc. Only a policy such as this would eradicate the shadow financial system. Also to be banned are economic transactions between the regulated financial system and peripheral institutions lying outside the regulated sector (e.g. business with offshore centres), as such a ban would not have any negative impact on economic development.

Derivatives should be traded only in regulated and controlled markets. This would mean the pure and simple elimination of OTC trade. Derivatives must be standardized, checked and approved by a state-run supervisory agency before they may be used. Mixing completely different types of assets in one structured product and repackaging securitized papers should also be banned. Such measures would not eliminate the risk of derivatives altogether (they should not be eliminated for they serve a useful economic function in transferring risk from agents not wishing to carry them to agents who are willing and able to bear them), but the process would be made more transparent. Such measures would reduce the economically harmful complexity of the market and reduce tax or other types of regulation arbitrage.

In some derivatives markets, trade should be open only to certain agents with special licences. For example, market participants in futures markets for oil, food or other natural resources should to some extent be involved with the market directly and not solely for speculative purposes. Institutions taking on risks in the market for credit default swaps, to give another example, should be adequately supervised to guarantee their ability to fulfil their contracts in the event of a serious crisis.

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multinational financial institutions, in case of a dispute between national supervisors and the European authorities, the European authorities may issue the decision. One disadvantage of this is that the European supervisory authorities are not integrated in one institution. At the European Central Bank, the European Systemic Risk Board was founded to oversee systemic risks in the entire European financial system. Unfortunately, the Risk Board is completely dominated by the Central Bank, not by independent experts.



Since the subprime crisis, supervisors in the United States have been empowered to regulate non-bank financial institutions and derivative markets. Similar regulatory arrangements are planned in Europe. Authorities can regulate derivative markets in a discretionary manner and may even prohibit some of the more dangerous activities, at least temporarily. However, regulations in effect are insufficient compared to what is needed. Not all financial institutions will be supervised adequately; hedge funds, for example, are required only to register but may otherwise continue the business model followed in the past. Not all derivatives are standardized, checked and approved by a supervisory agency, offshore centres prohibited to regulated markets, and restriction of agents trading in derivatives markets is still insufficient, for example in derivatives markets for natural resources.

### Buffers to stabilize the system

Once again, the financial system needs larger buffers to remain stable in the event of shocks. The Basel Committee on Banking Supervision (2010) has recently recommended a reform of Basel II which was accepted by the G20 in November 2010. The new proposal to regulate banks, known as Basel III, is oriented in the right direction. Under Basel III, minimum holding of high-quality equity increases from 2 to 4.5 per cent of total bank assets, to ensure that banks are better equipped to absorb losses.<sup>9</sup> A so-called conservation buffer of high-quality equity of 2.5 per cent of total assets is added, bringing total equity holding of high-quality capital to 7 per cent. If a bank cannot meet the requirements of the conservation buffer, dividend payments and management earnings must be curbed and share buy-backs limited. Finally, under Basel III central banks are given the discretionary power to force banks to keep an additional counter-cyclical buffer of high-quality equity between zero and 2.5 per cent of total bank assets. What is new in the Basel III proposal is that banks must keep a certain specifically defined minimum liquidity.<sup>10</sup> This measure was taken in response to the fact that during the subprime crisis banks kept liquidity in a form which evaporated when all financial institutions tried to sell their papers in secondary markets. Finally,

9. High-quality capital is common capital (the amount of money common stockholders would obtain in case of liquidation of the bank) plus retained earnings. Under Basel II, other types of capital such as goodwill or deferred tax payments with low loss-absorption capability played a more significant role. The very definition of high-quality capital should be harmonized, as differences still exist from country to country.

10. Regarding liquidity provision, two indicators are proposed: the Liquidity Coverage Ratio (stock of high-quality liquid assets divided by net cash outflow over a 30-day time period), and the Net Stable Ratio (the amount of available stable funding divided by the required amount of stable funding). In both cases the standard requires a minimum ratio of 100 per cent.

a ceiling on the allowed leverage ratio is also a new development. Banks are to keep 3 per cent of their assets as equity (which means that banks can give credit of around 33 times their equity). The Basel III proposals must be passed as national legislation and time will show how many of these provisions will in fact be implemented. Implementation of Basel III is expected between 2013 and the end of 2018.

One shortcoming of Basel III is that banks will still be allowed to use the disastrous pro-cyclical risk models. It makes no sense to allow banks to use these models only to seek to compensate their negative effects via anti-cyclical equity buffers. For the purpose of banking regulation, it would be much more reasonable to implement a modified standard approach in the spirit of Basel I. Basel I was rightly criticized for not distinguishing sufficiently between different types of credit awarded to firms and private households. But this could be remedied without renouncing the standard approach to equity holding. For example, corporate and private household debt could be subdivided into several categories, each with fixed weights for equity holding irrespective of the economic situation. In addition to such a regulation, counter-cyclical buffers of minimum equity holdings would still make sense.

But even more problematic is the fact that Basel III does not address the shadow financial system. Indeed, the higher standards set for commercial banks under Basel III might even go so far as to stimulate a greater transfer of activities to the shadow financial system.

Regulations such as those proposed under Basel III cannot create stability without the support of additional comprehensive regulations. Even equity holdings much higher than those proposed would not be able to prevent systemic banking crises. For instance, only between 2007, when the subprime crisis started, and the end of 2009 were US banks required to depreciate 4.7 per cent from their total assets as non-performing loans (Sinn, 2010). Another problem is that minimum equity becomes important only when a bank defaults and the equity can be used to satisfy depositors and other creditors of the bank. Minimum equity holding does not prevent a credit crunch when equity is destroyed by non-performing loans and banks are forced to reduce their credit volume to fulfil capital requirements. In this case large anti-cyclical equity buffers above the minimum capital requirements are imperative. With the construction of the conservation buffer and the possibility of additional equity holdings decided on a discretionary basis, Basel III appears to be taking this direction. However, the anti-cyclical buffers are not very high, especially considering that banks still use pro-cyclical risk models.

It is often argued that higher equity holdings by banks reduce credit expansion and GDP growth. If banks are forced to increase equity holdings within a short period of time this may be the case, but there is no sound theoretical argument to explain why higher equity holding reduces credit expansion in the long run as banks have the possibility to issue new shares. In financial markets demonstrating uncertainty and asymmetric information,

higher equity holding makes banks as well as the financial system and the economy more stable since it increases the loss absorption capacity of the system and reduces moral hazard. Indeed, low equity creates incentives to engage in high-risk strategies promising very high profit because failure does not incur much loss of capital.<sup>11</sup>

Past developments have shown that credit allocation by banks can go in the wrong direction and does not take into account macroeconomic stability. For example, in many countries, from the United States to Great Britain, Ireland and Spain, too much credit went to the real estate sector. At the same time, in many cases credit expansion to private households for consumption or credits to developing countries were too high and not sustainable. The outcome was over-indebtedness of (parts of) private households or entire countries. To prevent such developments in future, central banks should be granted discretionary power to enforce potentially high equity holdings for special types of credit. Another possibility would be to set credit ceilings for certain types of credit.

### Reducing the role of rating agencies

Before the outbreak of the subprime crisis, rating agencies failed to warn investors that the financial system was moving into an increasingly fragile situation. In fact, rating agencies were using the same pro-cyclical risk models as other financial institutions and thereby added to the instability. The role of rating agencies should therefore be reduced. This occurs automatically when all financial products are standardized, checked and approved by a supervisory agency and when banks follow a standard approach with regard to equity holding.

Rating agencies would also lose part of their function if local banks recovered their significance. Indeed, when a local bank in Europe buys securitized credits granted in the United States, it has no information about the debtors and consequently refers to rating agencies to obtain this information. However, when local banks or local subsidiaries of larger banks are engaged in long-term relationships with local firms, rating is superfluous since bank managers have their own privileged access to the situation of a firm. For example, the German savings banks owned by local communities and cooperative banking institutions which concentrate on local business activities were almost completely unaffected by the subprime crisis. Such banks should play a more active role in a reformed financial system.

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11. For neoclassical economists the traditionally highly appreciated Modigliani-Miller-Theorem states that in perfect financial markets, without asymmetric information, for example, the financial structure of firms does not change investment decisions (Modigliani and Miller, 1958). In this case higher equity is no problem at all.

The costs of rating should be borne by the buyer of financial products and not by the seller, as is still usual practice today. Finally, rating agencies should be supervised by government institutions.<sup>12</sup> State-run rating agencies could break the cartel of the three dominant rating agencies in the world.

Accounting standards cannot be left to two private institutions which in the past have catered to the interests of the financial industry. Accounting standards are as important as financial market regulation and should be recommended by a body similar to the Basel Committee on Banking Supervision. In fact, the Basel Committee already has an Accounting Task Force (ATF) as a sub-committee. It should substitute for the IASB and the FASB. Bookkeeping should revert to accounting values at historical cost and, in the interests of greater safety, below that level should market prices fall below historical cost. Such accounting standards lead to undisclosed reserves, for example when real estate assets increase in price and are booked at historical values. Undisclosed reserves make financial institutions and enterprises of all kinds more stable and there is nothing wrong with this. It is by far better than booking higher real estate prices at market prices during a real estate bubble, pretending to have high equity which then evaporates with the collapse of real estate prices. There would be nothing to prevent financial market firms from publishing additional information about market values should they be so inclined.

### Reform of destabilizing incentive systems

Managers and traders in financial institutions earned very high bonuses which were dependent on current profits and/or asset price developments. Such incentive systems were devised on the basis of the so-called “shareholder value” principle which seeks to align management’s objectives with the interests of the owners. High bonus payments based on current profits and/or current asset prices were perceived to be the best indicators for managerial behaviour in the interests of the owners.

In fact, however, since the 1980s this has led to an explosion of earnings for management which have increased even faster than dividend payments. More disturbing still is the fact that this has created incentives to maximize short-term returns even where such a strategy is harmful to long-term development. Owners and, of course, workers suffer from such short-term orientation when, for example, insufficient investment is made in research or training. Even Alfred Rappaport, one of the “fathers” of the shareholder value principle in the 1980s, criticized the obsession of short-term performance of this corporate governance system and demanded reforms (Rappaport, 2005).

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12. The newly created European Securities and Markets Authority (ESMA) registers and supervises rating agencies in the European Monetary Union.

To solve this problem, the discussion has focused on curbs to bonus payments and on the extension of the time period for measuring managerial performance. For example, in the European Union, a new law has introduced restrictions to the bonus system. Bankers are now entitled to receive a maximum of 30 per cent of their bonuses in cash immediately; the rest must be paid later and is linked to their long-term performance, with at least 50 per cent paid in options, shares, and other non-cash forms. Each bank will have to establish limits on salary-related bonuses (European Parliament, 2010). This legislation is an improvement, but it would have been better to set absolute limits to bonuses by law, at least in per cent of fixed salaries.

One extremely efficient method of curbing managerial earnings while at the same time supporting a long-term management strategy would be to reintroduce the stakeholder principle. Under this principle, management would be obliged to seek a compromise among the various stakeholders in a company: the owners, the workers, the creditors and the local community. In such a model management's strategy is controlled, including its earnings, and companies are more likely to follow a long-term strategy without profit maximization at all costs. John Kenneth Galbraith (1967) presented such a stakeholder model in the United States in the 1960s. He argued that management did not go out ruthlessly to reward itself but exercised restraint. He argued that in conditions in which everyone was merely seeking high individual gain, the corporation would be a chaos of competitive avarice. Group decision-making in a stakeholder model ensures that stakeholders control each other, and enforces a code of behaviour allowing all stakeholders to benefit (Vitols, 2010; Dullien, Herr and Kellermann, 2011).

## Tax policy

Tax policy has many instruments at its disposal to stabilize financial markets. Some of them will be mentioned here.

One proposal that has been a subject of ongoing interest is a financial transaction tax. Such a tax would apply to all financial transactions (at a level below 1 per cent), including highly speculative transactions in foreign exchange and derivative markets. It would not burden medium- and long-term oriented business activities to any significant degree, but rather would suppress speculation and arbitrage transactions based on very low margins. A financial transaction tax could apply to all international transactions, but would also be feasible in a single country. It has been estimated that, on a global scale, a tax rate of 0.1 per cent would generate tax revenues of around 1.5 per cent of the world's GDP (Schulmeister, Schratzenstaller and Picek, 2008). A financial transaction tax would be highly recommended to ensure that the financial industry shares the burden of the costs caused by the subprime crisis, but also in the interests of general public revenue creation.

However, such a tax alone would not be resilient enough to stabilize financial markets. The best illustration of this is the real estate market, where high transaction costs have not been sufficient to prevent disastrous bubbles.

Tax policy can reduce asset price bubbles via strict taxation of speculative gains. Regulations obliging investors to retain assets for a certain period of time may also reduce the incentive to speculate. For example, if a private equity firm were forced to hold a company for at least five years, there would be less incentive to pursue an unfriendly takeover of the company, divide it into pieces and sell the pieces for a quick profit. Another option would be to tax profits plus paid interest in companies. This would offer the advantage of not discriminating against higher equity holdings in firms. To tax profits and paid interest in the same way would also make tax arbitrage more difficult. This would significantly curb investor strategies of buying firms, substituting equity in the purchased company with debt and transferring interest to tax havens in an effort to reduce tax payments. Still another policy against tax arbitrage would be to tax a citizen's income in their home country, regardless of the country in which the income was earned.<sup>13</sup>

Money laundering, tax evasion, and circumvention of supervision and other regulations are concentrated in offshore centres and tax havens. For example, in 2009 around 60 per cent of hedge funds were registered in offshore locations or tax havens, among them 39 per cent in the Cayman Islands and 27 per cent in the US State of Delaware (IFSL, 2010). It would be easy to force offshore centres and tax havens to obey international standards in supervision or taxation or otherwise ban transactions with them. In a reform model, all financial institutions with transactions in banned offshore centres and tax havens would not be authorized to do business inside the country.

### International capital flows

A financial system which isolates risk-prone elements from the rest of the financial system requires capital controls. It makes no sense when domestic banks are not allowed to finance non-bank financial institutions yet the latter can go abroad to take out a loan and finance risky ventures. This is exactly what happened in Asian countries before the Asian crisis broke out in 1997.

International capital flows are unstable. Beginning in the 1970s, their deregulation led to a long sequence of high current account imbalances, exchange rate turbulence and currency crises (Herr and Kazandziska, 2011). A regulated financial system calls for international capital controls to afford central banks the instruments needed to control unstable international capital flows and to follow, at least to a certain extent, a domestic-oriented monetary

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13. Here the United States sets a positive example. Citizens are taxed on worldwide income and taxes paid in other countries may be deducted from the tax burden.

policy. This is not possible if capital flows are uncontrolled. Current account imbalances in a new system should be kept small. This not only implies capital controls but also a global mechanism to prevent countries from following a mercantilist policy for high and long-term current account surpluses. The debates during the Bretton Woods negotiations in the 1940s could be a starting point for the development of such a system (Keynes, 1941).

Central banks should have the discretionary power to ban certain capital flows at certain times, and also the freedom to decide which instrument to use. To date there are no legal restrictions for such regulations and capital controls are compatible with membership in the International Monetary Fund and the World Trade Organization. Capital controls have many different levers. One is to tax certain capital flows. However, such a financial transaction tax is not strong enough to stabilize capital flows. Much stronger instruments include direct prohibition or quantity controls of certain capital flows, for example international portfolio investments or international credits. To reduce international capital flows, other instruments are available. Legal regulations can compel pension funds and insurance companies to invest only a small amount of their assets, or none at all, in emerging markets and/or other countries. Certain banks, such as savings banks or cooperative banking institutions, can be prevented from pursuing international business.

## Conclusion

Financial markets should be reformed in such a way that they support sustainable economic development and low unemployment without adding to income inequality.

- In the interests of sustainable economic development the financial system must deliver sufficient credit for productive activities at low interest rates. It has to support a Schumpeterian-Keynesian credit–investment–income mechanism which is the backbone of production and employment. At the same time it must finance innovation and the transition towards ecological and sustainable means of production and consumption. Consequently, it would be misguided to eliminate financial markets as a key area of the economic system. The task is rather to regulate them in such a way that they provide necessary support to economic development.
- The destabilizing nature of financial systems could be significantly reduced if the commercial banking system as well as insurance companies and pension funds were strictly controlled, international capital flows regulated, risk-taking institutions such as investment banks isolated from the rest of the financial system, all non-bank financial institutions regulated, the shareholder value principle overcome, unions and other stakeholders able to influence management, and offshore centres and tax havens prohibited.

For this to occur, the non-bank financial sector must shrink substantially. Also, derivatives have to be kept quantitatively small, standardized and checked by state-run supervisory agencies. In such a system, commercial banks would be strongly encouraged to focus anew on their core mission of providing loans to businesses and households.

In the recent past, the financial system has siphoned an increasing share of income and has been a significant contributor to income inequality by forcing firms to pursue high-profit mark-ups. Keynes (1936, p. 376), in another era, once evoked the possible “*euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist...*”. He envisioned a stage of capitalist development in which real interest rates and normal profits would go down to around zero and only innovative entrepreneurs would earn a profit. So far his vision has not materialized. However, a reformed financial system could help to bring this about. Indeed, one option for a regulated financial system would be to set deposit rates by the central bank whereas real interest rates would be positive but low. Fixing deposit rates also adds to economic stability as competition between banks is reduced (see also Hellmann, Murdock and Stiglitz (2000) who recommend deposit-rate controls). In a highly regulated system, the central bank could fix interest rates and at the same time the amount of credit to be issued by banks. Such a system would ration the credit volume. But credit rationing in all financial systems already exists, for even without such regulations not all credit subscribers paying the market interest rate will obtain credit. The advantage of simultaneously fixing interest rates and credit volume is that real interest rates can be set at low levels and even restrictive monetary policy can be implemented without increasing interest rates simply by reducing the credit volume of commercial banks.

A financial system as outlined above is not utopian. For instance, it existed more or less in the United States as well as in other industrial countries after the Second World War. Comprehensively regulated systems with interest rate control, international capital controls and almost no non-bank financial institutions existed, and to some extent still exist in various versions in all the economically successful East Asian countries (Japan, Republic of Korea, Malaysia, Taiwan) (Stiglitz and Uy, 1996). Since 1978 and to this day, the Chinese financial system also fits such a model (Herr, 2010). The financial systems in these countries offered sufficient and affordable credit to the manufacturing sector and were able to stimulate growth and employment without risk of financial market instability.

Current regulations of financial markets and those that are now being considered may bring some improvement but will not be sufficient to guarantee stability. While many of the more radical reforms recommended in this paper may not seem politically feasible for the time being, the fragility of the financial system will continue relentlessly, and history may well create new



windows of opportunity for meaningful change. If such an opportunity presents itself, we should be aware of which direction to take.

A clear vision about the direction in which reform of the financial system should go is of key importance to unions. Past developments in the financial sector not only led to high and volatile unemployment, they also contributed to unequal income distribution, precarious employment conditions and managerial attitudes generally hostile to unions. Financial market reforms may require political decision, yet unions should not shy away from demanding radical reforms in financial systems. Such involvement will rather strengthen the influence of unions and help to overcome the fundamental market ideology which has been depriving so many of decent working conditions and of a decent life.

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