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Economic Stagnation Postponed: Background of the 2008 Financial-Economic Crisis in the EU and the USA

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Abstract. The significant increase since the early 1980s in the share of income accruing to capital (rather than labor), in both the US and the EU countries, created the potential for economic stagnation. The realization of stagnation was effectively postponed by the particular development of the banking sector in these countries, notably in the increasing amounts of credit granted to wage earners. To the extent that such lending will be curtailed in the aftermath of the recent financial-economic crisis, stagnation threatens to present itself. Within the confines of capitalism, this dilemma can only be overcome by a significant shift in the macroeconomic pattern of income distribution that realigns consumption and income. While particular banks and banking policies – usually blamed for the crisis – indeed played an important role, the roots of the crisis are located at a deeper level. The implication is that the economic problems we face will be much *more* difficult to overcome than the usual analyses suggest.

Key words: macroeconomic distribution of income; expenditure; stagnation; monetary circuit approach

Introduction

The development of the banking system in the decades before 2008, in fact postponed the economic stagnation implied by the divergence between income and consumption. This potentiality for a prolonged period of near-zero growth threatens to express itself in the aftermath of the financial-economic crisis.

Many elements and contradictions cannot be discarded or overcome within the capitalist system. These include the monetary value and profit criteria for production, as well as the trading of labor-capacity (and therefore the capital–labor opposition) that are the cornerstones of capital accumulation. By contrast, in my view, economic

stagnation or banking crises are not necessarily *inherent* to capitalism (although certainly not unlikely). That said, the elements that characterize the development of capitalism in the USA and the EU, outlined below, were gradually built up over a period of thirty years and have so become ‘hardened’ within the system. Hence, these elements might, in principle – with, however, much difficulty and time – be overcome within the system. The analyses and proposals of this brief paper will remain within the strictures of the capitalist system.

The gap between profits and investment

I first briefly indicate the determinants of the realization of surplus-value and profits. For the purposes of this paper, I define surplus-value realized (SVR) as the sum of the profits of enterprises (R) plus the net interest paid by enterprises to financiers, including banks. Hence R is the sum of retained profits and dividends of enterprises. (All equations and numbers in this paper are macroeconomic in nature.)

$$R + \text{net interest paid by enterprises} = \text{SVR} \quad (1)$$

For the purposes of this section, I neglect the government and foreign sector. Then, *given* production and the determinants of the production of surplus-value (not treated in this paper), the realization of surplus-value is determined by the macroeconomic expenditure categories of investment (I) and consumption (C), minus wages (W) – all in the monetary units:

$$\text{SVR} = I + C - W \quad (2)$$

This is a Kaleckian type of equation when the determination is read from the right- to left-hand side (that is, expenditure determines surplus-value realized).¹

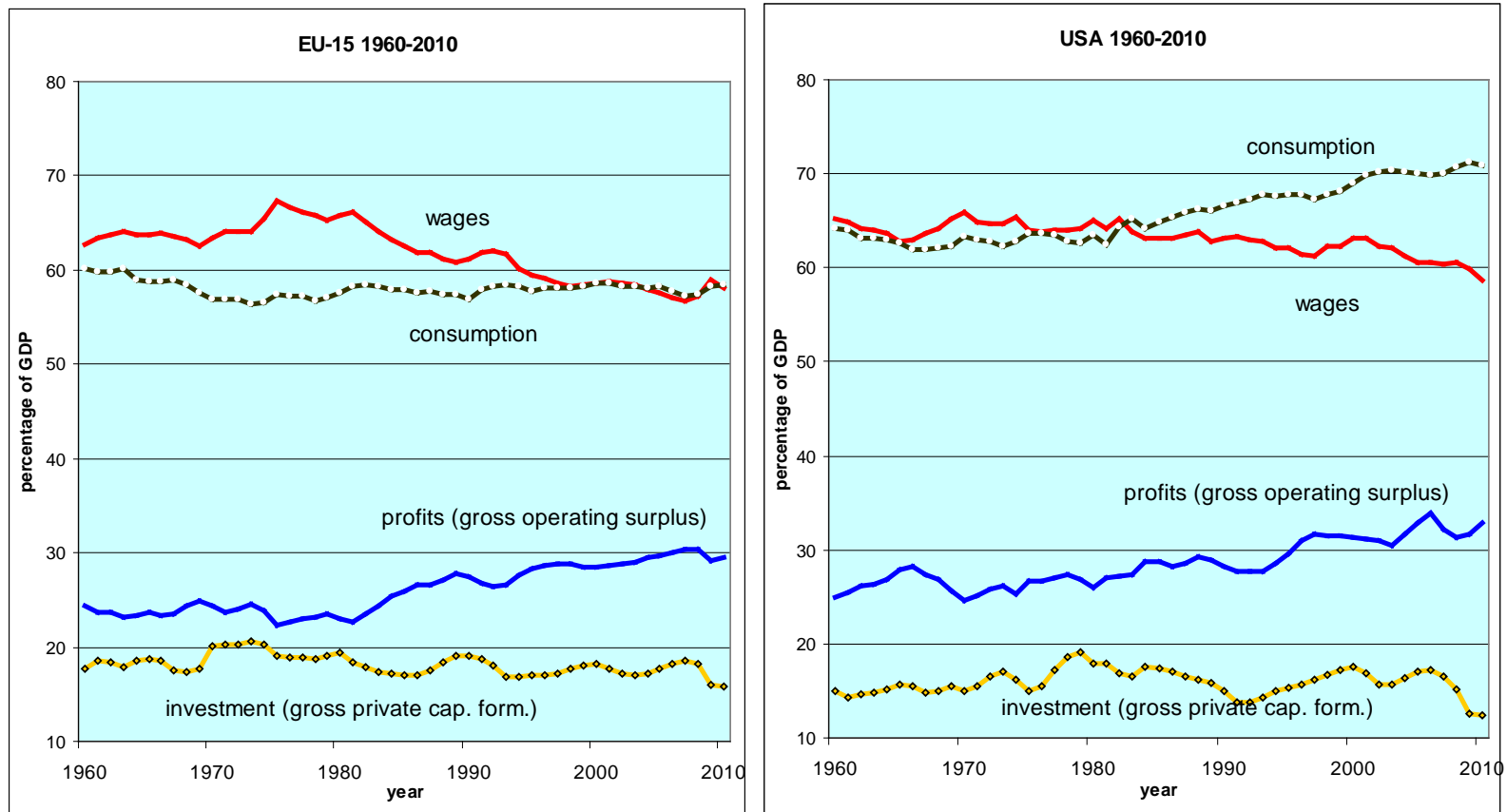
It is often expected that increasing profits are an incentive for increased investment. However, when we consider the era of so-called “neo-liberalism” (from about 1980) for the US and the EU-15 countries, the data show the reverse.² The two bottom lines of the graphs in Figure 1 show profits increasing (‘broad’ profits, including interest) while investment was decreasing (each measured in GDP shares).³

¹ This Kaleckian equation is analogous to the Keynesian equation of: $W + \text{Profits (broad)} = Y = C + I$.

² The EU-15 are the 15 countries that made up the European Union until 2004 (this is a useful group because much of the relevant data for these countries often go back to 1960).

³ Investment is gross investment of enterprises and the capital income is the gross operating surplus (including net interest). Capital income and wages have been adjusted for wages assigned to independent producers. For the data see the EC/Eurostat AMECO data base http://ec.europa.eu/economy_finance/db_indicators/ameco/index_en.htm (accessed 30 April 2011).

Figure 1. Macroeconomic income and expenditure shares in GDP: EU-15 and USA 1960-2010 ⁴



Data source: EU, Economic and Financial Affairs, Economic databases and indicators, AMECO data base, accessed 30 April 2011. See note 3 for additional details.

⁴ The EU profits share 1960-1990 is in ECU and excludes Luxembourg and East Germany; the EU profits share for 1960-1969 excludes Belgium, Denmark, Ireland, Spain, France, Italy, Netherlands (data not available).

Alongside the increasing share of capital in total income, we can see its mirror in the decreasing share of labor income. In this paper I will not expand on the reasons for this change in the distribution of income, which relate to developments in the *labor market* and the *production* aspects of income determination.⁵ In brief, the enduring vast unemployment following the 1981-82 recession shifted the balance of power between enterprises and labor, such that wage increases could continuously be held below increases in labor productivity.

Components of the Gap between Profits and Investment

How can we explain the increasing gap between profits and investment? The key lies in consumption and wages. Rearranging equations (1) and (2) we have:

$$R = I + C - (W + \text{net interest paid by enterprises}) \quad (3)$$

In the EU-15 we see a huge decline in the wages share in GDP from the early 1980s onwards, in total about 10 percent (see Figure 1 to trace this development over the past 50 years). At the same time, however, the consumption share remained roughly constant. In the US this development is even more dramatic: the wages share declined in combination with *increasing* consumption, so giving rise to a gap of about 10 percent.⁶

Declining savings out of wages

These changes can be partially explained by a macroeconomic decline in savings out of wages (a decline in the flow of savings), implied by the difference between wages and consumption in Figure 1 (in the EU this difference is near zero around 2010; in the US macroeconomic savings rate was already nearing zero around 1980). This situation, as explained below, favors enterprises.

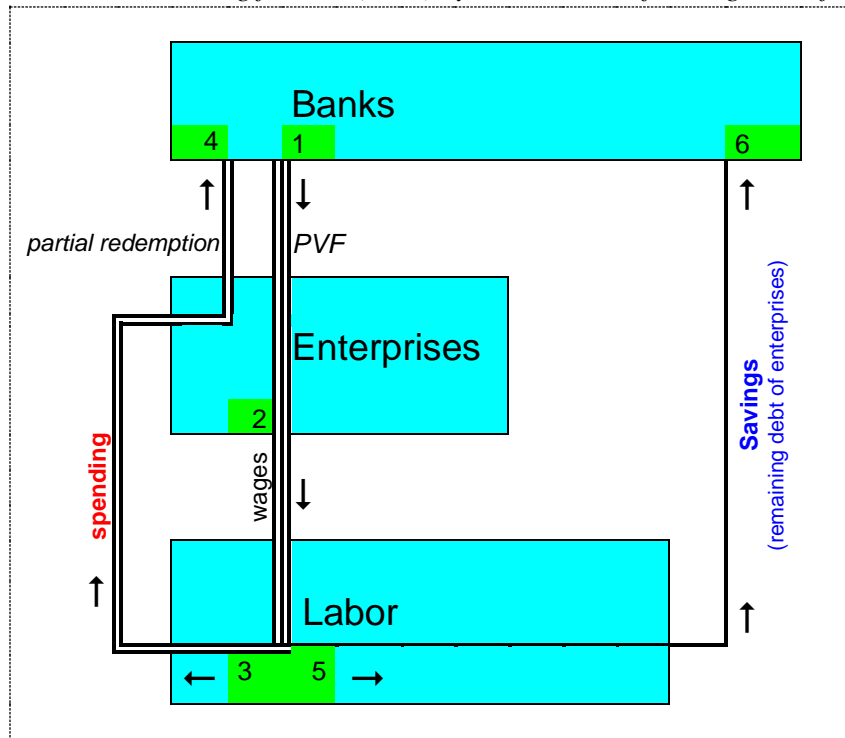
Using a monetary circuit approach, it can be seen that the initial finance for investment and for wages payments is accommodated by bank credit. Figure 2 shows wages payments financed by a *flow* of bank-provided credit that I will call ‘pre-validating finance’ (PVF) (streams 1-2-3). This figure presents the ‘case’ of savings by labor (stream 5-6). The result is that enterprises end up with a *stock* of debt owed to banks, equivalent in size to the savings by labor. We therefore have a triadic credit-debt relationship between banks, enterprises and labor, one that is normally favorable for banks in terms of interest margins.⁷ On the other hand, these savings are a nuisance for enterprises, not only because spending is lower but especially because of the continuing accumulation of a stock of debt.

⁵ There are four determinants for the distribution of income: (1) the labor market; (2) production; (3) price setting; (4) expenditure.

⁶ Given the number of people involved, only a very minor part of this consumption increase can be explained from increased consumption out of surplus-value (profit and interest incomes).

⁷ Of course, *ex-post* the initial finance by banks, wage earners might substitute for the enterprises’ stock of debt with banks, for example by buying bonds from enterprises (either directly or indirectly, for instance via pension funds).

Figure 2: Pre-validating finance (PVF) by banks: case of savings out of wages



It can be seen from Figure 2 that when savings by labor decline (spending consequently increases), enterprises, *ceteris paribus*, build up less debt so that their interest payments decline (see equation 3). At the same time then, banks loose on this front. Declining savings out of wages therefore affects the distribution of surplus-value between banks and production enterprises, in favor of the latter.⁸

Colonization of the future

The further step is the movement of consumption *beyond* wages. It is, of course, well known that this divergence was financed by direct consumption credit and by indirect consumption credit via mortgages – the latter in face of (expected) increasing collateral value. For the first time in history we saw consumption being financed on a massive scale by banks and next, in securitized form, substituted for by wealthy portfolio investors, mostly via hedge funds. In this way, laborers compensated what they had lost on the wage front. All along, this prevented aggregate demand stagnation, even if this was not the motive.

However, loans require interest and must, at some point, be redeemed. Hence the banks – as well as other financiers via the banks – made claims on future wages of laborers. Photis Lysandrou aptly called this the “colonization of the future.”⁹ Because this implies less future spending, the effect was a postponement of stagnation.

⁸ Where other financiers partially substituted for the stock of debt (i.e. an ex-post substitution for the non-redeemed part of the PVF) it is of course these financiers that receive a smaller share of surplus-value.

⁹ Photis Lysandrou (2009), *Global Inequality and the Global Financial Crisis: The New Transmission*

Conjunction of Interests

Due to a conjunction of interests, all the elements for this postponement of stagnation seemed to fit, that is, until about 2007.¹⁰

First, the most direct beneficiaries were *enterprises*. After the initial and continuing wages moderation – that of wages growth lagging behind labor productivity increases – enterprises saw a decrease in the proportion of savings out of wages and hence, through higher spending, a decrease in the *stock of debt* owed to banks (as earlier indicated, PVF can increasingly be redeemed through consumption expenditure; see Figure 2). On top of this, once banks provided laborers-consumers with consumer credit that was spent with enterprises, there was – for an amount equal to the amount of consumer credit – an *ex ante* substitution for PVF. Thus consumers took on a part of the credit that banks “normally” would have provided to enterprises. This is illustrated in Figure 3: the consumer credit stream 1-2-3 that is spent with enterprises, substitutes in part for the PVF by banks (stream 1-2 from Figure 2 reduces to stream 4-5 in Figure 3).¹¹ In sum, enterprises pay lower wages, as well as less interest to the financiers (including banks).

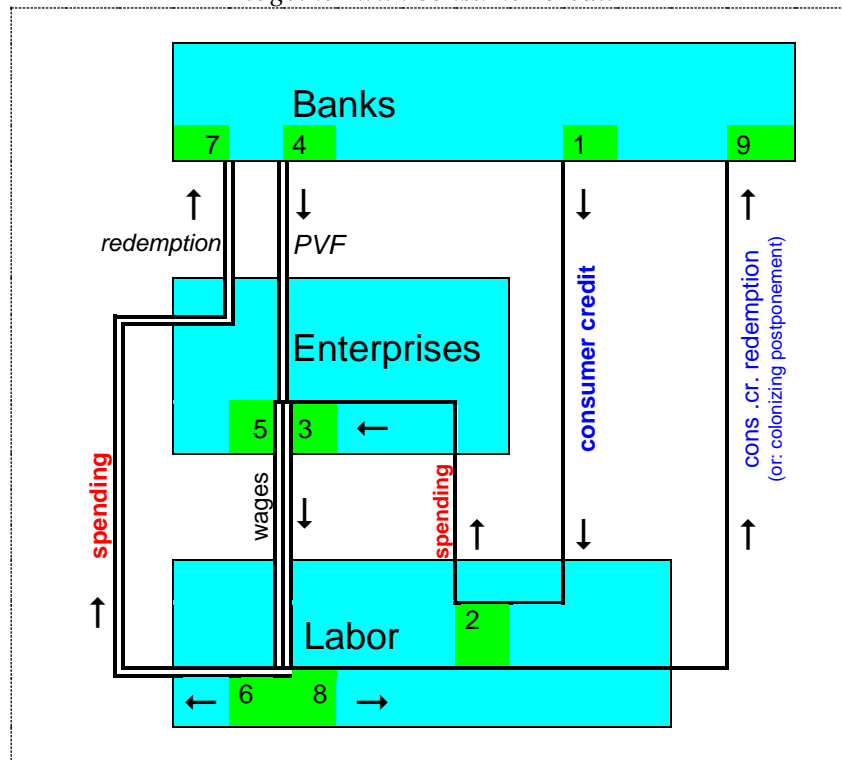
Mechanism, London Metropolitan Business School, Working Paper Series No. 5.

http://www.londonmet.ac.uk/fms/MRSite/acad/lmbs/RESEARCH%20CENTRES/CIBS/Working%20Papers%20new/Lysandrou%20Working%20Paper%20No_%205.pdf .

¹⁰ I am not arguing that the grand process of financing the divergence between wages and consumption was a concerted action. I merely indicate that there was a temporary, contingent fit so that no interest groups had a motive for behaving differently.

¹¹ Note that in case the consumer credit is provided by the enterprises themselves – or specialised branches thereof – the enterprises would require a PVF for that credit. Hence this case ultimately reduces to a sub-case of that of Figure 3.

Figure 3: Pre-validating finance (PVF) by banks: case of zero savings out of wages together with consumer credit



Note that Figure 3 shows the simple case of an immediate redemption of consumer credit out of wages (stream 8-9). This is the case of the pure substitution of consumer credit for PVF. In actual fact this redemption was – and remains – postponed, resulting in a *stock of debt* owed to banks by laborers: the colonization of the future.

Second, what banks lost in interest from enterprises (their share in surplus-value) they won in interest from labor (their share in wages), and most often with an interest bonus (a higher margin). Further, for those mortgages that banks resold via securitization, they received commissions.¹²

Third, the banks' securitization of the mortgages provided an outlet for *wealthy financiers* that cried for portfolio investment opportunities. Thus in the relatively short period from 2000 to 2007 the securities issuance of banks in the USA and Europe quadrupled from US\$400 to nearly US\$1600 billion.¹³

Enterprises were thus the most direct beneficiaries of this consumer credit constellation. What about banks? Even if the behavior of banks resulted in the postponement of stagnation, it is doubtful that they in fact had an interest in financing the wages–consumption divergence (I am not hinting at the financial crisis: in that

¹² In a report from the Basel Committee on Banking Supervision it is calculated that over the fifteen years just preceding the crisis (1993-2007) banks secured an, after tax, average rate of profit of 14.8% on their own capital. See “An assessment of the long-term economic impact of stronger capital and liquidity requirements”, BIS, August 2010, page 48. http://www.financialstabilityboard.org/publications/r_100818a.pdf.

¹³ This is amplified upon in the paper by Photis Lysandrou (2009), see note 8.

respect it was not in their interest anyway).¹⁴ Perhaps they initially did not foresee that vast increases in consumer credit implied a vast substitution for the more or less stable, and generally more reliable, PVF to enterprises. In effect banks saw the normal PVF *increase* run dry (i.e. the increase in PVF “normally” associated with economic growth). Through substitution of consumer credit for PVF, the aggregate of banks laid the mine-field of risky assets.

Further, once the process of substitution was well under way, there were no sensible institutions to prevent its continuation: neither central banks nor other supervising authorities, nor governments. States had declared the “independence” of central banks, while central banks – as intertwined with commercial banks via personal ties – declared “self regulation” for commercial banks. Commercial bankers may not have sat at the Basel assemblies, but they were important consultants for its weak ‘framework’ and weaker performance.

Course of the Crisis

The course of the crisis itself is not particularly difficult to follow, and it has been detailed at great length in the literature. Because most banks were weak on the assets side of their balance sheet, they had reason to distrust other banks in that respect. Once one or several main banks got into actual trouble – i.e. insurmountable debts to other banks – the distrust had a domino effect around the world, effecting the US and the EU most directly. Ultimately even the banking system as a system of money transfer (payments) nearly collapsed: banks did not want to receive payments from other distrusted banks as this puts the one bank in risky debt with the other. States ultimately had to step, nationalizing or semi-nationalize major banks, so as to at least preserve the payments system.

In sum, enterprises and banks had no choice but to accept reduced profits. The portfolio investors who had bought the securitized loans were the least affected group because banks had generally provided off-balance sheet guarantees. The biggest misery was imposed on the increasing numbers of the unemployed, with still-employed laborers in a close second spot, facing wage cuts and ultimately lower living standards through cuts to state-provided welfare.

Problem of Stagnation Not Resolved

The financial and economic crisis is the expression of the *reaction* to the substantial shifts in the distribution of income beginning around the early 1980s. However, the crisis does not resolve the problem of potential stagnation. On the contrary:

- *If banks do not face more effective regulations* than what is currently being proposed, the banking system risks renewed collapse. A new round of massive state assistance, apart from being politically less likely, seems beyond many states’ means (that is, beyond the means of the modal tax payer). *If banks are effectively regulated*, then the postponement of stagnation will come to an end: relative

¹⁴ Even so it may have been in the interest of directors and other managers who received extraordinary bonuses.

consumption will substantially decline as consumer credit stagnates and plays a lesser role in financing consumption.

- Besides this, we have the colonization of the future labor incomes: income claims that will also result in a relative decline of consumption.
- With a relative decline in consumption the investment of enterprises will also slacken.¹⁵
- Reliance on China and India is also not a likely solution. Such countries will not allow the US and EU to boost their exports without equivalent imports.

In sum, the economies of the US and the EU are likely to enter a period of stagnation.

What to Do?

In any case, an actual stagnation will affect profits and the rates of profit. In order to prevent actual stagnation, the overall wages share in GDP would have to rise considerably. To begin with, wages should at least keep up with labor productivity growth. If enterprises wish to prevent further (worse) crises, they will have to get accustomed to rates of profit far lower than those seen in the past decades. Rates of profit norms are, after all, mere conventions. A considerable increase in the wages share in GDP is in the interest of workers but also in the collective interest of enterprises.

Within the individualistic market system, the big question is how such a radically new consensus would float to the surface? For one thing, it would necessitate a major turnaround in the attitudes of employers' federations toward wage negotiations. In case such action would not come forth spontaneously the governments in the EU and the US could try to achieve a similar result through redistributive taxation. In this regard, the most efficient course would appear to be decreasing taxes on consumption (e.g. value-added taxes) with an equivalent increase in taxes on the top layers of wealth (financial capital/property), combined with international taxation treaties to prevent flights of capital.

This would require a momentous transformation of the political-economic 'wisdom' of neo-liberalism. However, if the political-economic wisdom does not turn of its own accord, stagnation might force the wheels to turn.

¹⁵ An additional and vast 'deepening investment' might in principle keep up investments but there seems to be no market incentive for these to come about at just the right time, in large enough amounts. An obvious field for such investments might be that of non-conventional energy. A "market" incentive for that might be a heavy taxation on conventional energy. The problem with such a solution is that this would *further* depress consumption in the following two decades – and hence non-deepening investment. Such a program would have to be combined with an intensification of the measures discussed in the next section.