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Neoliberalism, Income Distribution and the Causes of the Crisis

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Neoliberalism, Income Distribution and the Causes of the Crisis¹

The financial crisis that began in summer 2007 has since turned into the worst economic crisis since the Great Depression. Its immediate causes are to be found in the malfunctioning of the financial sector: securitization of mortgages allowed for a fast growth of credit and lowered credit standards as banks believed they had passed on credit risk; this fuelled a property bubble; statistical models, that turned out to be based on short time samples, were promised to reduce risk by constructing ingenious portfolios; well-paid rating agencies decorated the new assets with triple A ratings; banks shifted credit off balance sheets into structured investment vehicles; finally, capital inflows from Asian countries that wanted to accumulate reserves provided ample liquidity for this process. Obviously the financial system needs to be fundamentally overhauled. While these mechanisms were indeed important, this paper argues, they are only half of the picture. The focus on the flaws in the financial system may hide other causes of the crisis. The polarization in income distribution, in particular, tends to get glossed over as a potential cause of the crisis. This is not to deny the importance of financial factors. The crisis erupted as financial crisis for good reasons. The underlying accumulation regime had financial expansion as one of its key building blocks. However, what is at stake is more than financial system. This paper will thus argue that the present crisis should be understood as a crisis of neoliberalism. Financial deregulation is one of the components of neoliberalism, the polarization of income distribution is another one; it is their interaction that provided the grounds for the crisis.

In a nutshell, our story is the following. Neoliberalism has led to a shift in power relations between capital and labour. As a consequence income distribution has shifted sharply in favour of capital. Economically this has a dampening effect on domestic demand (as demand is wage led in the world as whole) which provides the background in front of which the macroeconomic imbalances that erupted in the present crisis have to be understood. Remarkably, increased profits have basically nowhere translated to an investment boom. The change in distribution has interacted with macroeconomic changes caused by financial deregulation, or, more broadly speaking, by financialization. Financial deregulation has a international as well as a domestic dimension. Deregulation of international capital flows has

¹ Some sections of this paper build closely on previous work by the author, in particular on Stockhammer (2008), Stockhammer and Ramskogler (2009), and Stockhammer (2010).

allowed countries to temporarily sustain large current account deficits – as long as financial markets were willing to provide the corresponding capital inflows. Indeed, capital flows rather than trade flows have become the prime determinant of exchange rate movements and for many countries, boom-bust cycles driven by capital inflows and consequent abrupt outflows (and currency crises) have been the most important feature of the finance-dominated accumulation regime.

As some countries have been able to run substantial current account surpluses (while others run deficits) international financial liberalization has created a new scope for different trajectories across countries. In a first group of countries domestic financial deregulation has provided a key driving force of growth by giving households improved access to credit. This has – typically in conjunction with real estate bubbles – led to a *credit-driven consumption growth*. These credit-led economies have proven the main engine of growth by means of a consumption boom. They have also run substantial current account deficits. A second group of countries has relied on *export-driven growth* (and subdued domestic consumption) and run substantial current account surpluses. Two key sources of the crisis, debt-driven consumption and international imbalances are thus linked to the interactions of financial liberalization and the polarization of income distribution.²

The remainder of this paper is structured as follows. Section 2 gives an overview of the present crisis and its metamorphoses. Section 3 discusses neoliberalism and highlights different interpretations. Section 4 analyses changes in income distribution. Section 4 presents the characteristics of the finance-dominated accumulation regime, in particular its effects on investment, consumption and net exports and it highlights the emergences of two different growth models. Section 5 concludes.

2. The crisis 2007-2010

In mid 2006 house prices in the USA started to decline. With hindsight, that marks the beginning of the crisis, even if it attracted little attention at the time. Rapidly rising house prices, and the mortgage lending that came with it, had been the basis of a boom driven by credit-financed consumption and construction investment in the USA. As will be discussed later, the structural causes of the crisis include the deregulation of the financial sector which

² Horn et al (2009) develop a very similar argument.

gave rise to a wave of financial innovation, i.e. new ways of creating debt, and the polarization of income distribution. It came with international trade imbalances and huge capital inflows to the USA. But this section will give a brief overview of the unfolding of the crisis itself.

The crisis broke out in a seemingly obscure niche of the US financial system: the subprime market, that is the market on which derivatives on low-quality mortgage credit; thus the initial name of the crisis as *subprime crisis*. This is a rather small segment of the overall mortgage market, though it accounted for a substantial part of the growth in the years before the crisis. As subprime credit is, by definition, of low quality, it was the natural field for the kind of financial engineering, securitization, that was supposed to reduce risk. What was going on here was the extreme form of what happened on a much broader scale in the entire mortgage industry. In August 2007 the crisis spilt over into the interbank market, where banks lend to each other, usually very short term. The interbank market is at the very centre of the modern financial system. Interest rose to more than one percentage points above that on government bonds. This increase in the risk premium of lending meant that banks did not trust each other. And rightly so, as it turned out. Central banks reacted quickly and pumped billions (of dollars and euros) into the market to maintain liquidity.

However, while things stabilized the crisis evolved. In spring 2008 Bear Stearns, one of the leading investment banks, was bankrupt and could only be sold with the FED guaranteeing some 20 bio US\$ worth of assets. A first (small) fiscal stimulus packet was implemented in the USA, but the impact on the real economy outside the USA was limited. In August/September 2008 the crisis turned into a full scale *financial crisis* – and it did so with a big bang: Lehman Brothers, one of Wall Street's leading investment banks, went bankrupt. The end of the world (or at least of big finance) as we knew it, seemed to have arrived. Interest rates soared (interest spread rose to several percentage points) and liquidity froze.

Again economic policy reacted. The principles of neoliberal free-market economics were suspended for a few weeks. Central banks provided more liquidity, but that proved insufficient to stabilize markets. Governments had to intervene directly: AIG, an insurance firm that had insured huge volumes of credit derivatives, was taken over by the state as were Fannie Mae and Freddie Mac, the two state-sponsored mortgage refinancing giants. Within a few weeks the recapitalization financial institutions and massive guarantees for interbank

credits became mainstream economic policy. Recapitalization meant that governments effectively were nationalized (fully or partly) financial institutions – but contrary to private shareholders they were eager to abstain from interfering with management priorities. In late October 2008 a EU summit issued a statement that no systemically important financial institutions would be allowed to fail – a capitalism without bankruptcies was declared!

By fall 2008 the financial crisis had turned into a full blown *economic crisis*. Income in most developed countries shrank at a speed not seen since the 1930s (in most countries by around 5%). And it not only hit those countries that had experienced property bubbles, but also countries like Germany and Japan (where property prices had been practically flat) and it spread to the emerging countries. Eastern European countries were particularly bad hit, with the Baltic countries suffering GDP declines by around 20%. The IMF had to be called in to save Hungary, Pakistan and the Baltic states. But the most conspicuous symbol of the downturn was certainly the fall of GM: once the world's largest firm and employer, it now had to be rescued by the state.

While complete meltdown seemed imminent in fall 2008, in the course of spring 2009 it became clear that the – historically unprecedented – scale of government intervention had prevented outright collapse. A cascade of bank breakdowns could be prevented by rescue packages that amounted to 80% of GDP in the USA and the UK (UNCTAD 2009, Table 1.8) and by the FED expanding its balance sheet by a trillion US\$, mostly by acquiring assets that it would not have touched in normal times. Risk premia remained elevated, banks were making phenomenal losses, unemployment started rising, but normality of a sort returned. And, apparently, the pressure to reform the system had receded. Earlier declarations of a fundamental restructuring of the financial system had been forgotten and the debate on reform turned into specialists' debate into technicalities, with all but private bankers and central bankers being excluded from the decision making circles. The arrogance of the financial elite, however, is best captured by the debate on banker management's pay. Despite the obvious disaster in finance, its leaders wanted to cash in again.

But the normality that was about to restore itself was not quite the normality of before the crisis. After all, the crisis was by no means over. Indeed, for large parts of the population, it only had begun, when for the bankers it was almost over. Production fell and unemployment rose. In the USA foreclosures were rising. People lost their jobs and their homes. And there

was another devastating effect of the crisis: budget deficits were increasing, surpassing 10% of GDP in many cases. So in the course of 2009 the crisis thus took its next turn: a *fiscal crisis*. This has been lingering for several months and had already erupted in central and eastern European countries, but its most prominent victim in winter 2009/10 was Greece and with it the Euro system.

In January/February 2010 Greece faced punitive interest rates on its (public) debt issues. Greece had fudged public debt statistics (with the help of leading Wall Street banks) and now had difficulties refinancing its debt. But Greece was not alone, the other Mediterranean members of the Euro area faced similar problems. Indeed, what had been exposed was fundamental flaw in the construction of the Euro system. With exchange rates frozen, the southern countries had, despite much lower inflation since adopting the Euro, slowly, but steadily by lost competitiveness to Germany and its economic satellites. Germany's net exports (mostly to other Euro countries) amounted to more than 5% of GDP. This was achieved by ruthless wage suppression and, consequently, low inflation rates (Lapavistas et al 2010). The Euro area had no instruments to deal with internal imbalances, other than trusting labour market flexibility to adjust the price levels. The other EU countries vaguely promised support and asked specifically for austerity.

The Greek problem was the tip of an iceberg in another sense as well. Most countries now face sharply increasing levels of government debt due to the crisis and it is not clear when and how the fiscal could be solved. The budget cuts that are envisioned in many countries will imply a cut back in welfare states, a paradoxical outcome for what started as a speculative financial crisis has ended up as a crisis of the welfare state. After the banks have been saved, it is the lower classes that are asked to pay the bill of the crisis.

3. Neoliberalism

The decades after the Second World War were characterized by what has been called the Fordist accumulation regime, which was based on a social-Keynesian mode of regulation.³

³ Regulation theory regards the macroeconomic dynamic (described as the "accumulation regime") as embedded in a particular institutional setting (the "mode of regulation"). While there is an agreement that the Fordist accumulation regime has come to an end in the course of the 1970s, there is no agreement on how to characterize the post-Fordist regime. Classical works of the (French) Regulation Theory include Aglietta (1979), Lipietz (1985) and Boyer (1990). Similarities between the Regulation Theory and the (American) Social Structures of Accumulation approach (Gordon, Edwards and Reich 1982, Bowles, Gordon and Weisskopf 1983) are now

Partly in response to the Great Depression, partly in response to the rise of socialist labour movements, governments assumed an active role in managing the economy, the welfare state was expanded and the financial system regulated. Full employment was a policy goal and, in many cases, was approximately achieved. As a result, capitalism experienced what has sometime been called a ‘golden age’ of prosperity – and this prosperity was widely shared. Wages grew in line with productivity and income distribution was relatively even. Fordism was as an accumulation regime characterized by mass production and mass consumption.

Fordism came into crisis in the course of the 1970s. While the debate on its deeper causes is still going on, its symptoms were clear: waves of labour unrest, a (by today’s standards: mild) recession, rising inflation and rising unemployment. Roughly from the mid 1970s trend productivity growth was substantially lower than before. Economic growth rates should not recover to the golden-age rates and, in particular in Europe, unemployment would remain elevated thereafter. Whatever the reasons, with hindsight it is clear that the late 1970s/early 1980s mark watershed, the switch to neoliberalism. Neoliberalism began with the change in monetary policy and a sharp increase in interest rates, but it ushered in a much broader change in government priorities: a return to orthodox economic policies that regards low inflation and balanced budget as the key policy goals and, claiming that government could do nothing to lower structural unemployment, effectively accepted high unemployment rates.

Neoliberalism turned into a full mode of regulation in the course of the next two decades.⁴ It was characterized by a retreat of labour, deregulation of the financial sector and globalization. In the Anglo-Saxon countries neoliberalism came with an outright attack on organized labour. The miners’ strike in Great Britain and the air traffic controller strike in the USA marked bitter defeats for labour. In continental Europe the organisational strength of labour was eroded by two decades of high unemployment, welfare state retrenchment and globalization. The effects of this in income distribution will be discussed in the next section.

widely recognized (e.g. McDonough and Nardone 2006). The question how national accumulation regimes interact has received limited attention within the regulationist approach. Becker (2002) and Becker and Blaas (2007) highlight differences along the axes of ‘intraverted’ versus ‘extraverted’ accumulation and ‘productive’ versus ‘fictitious’ accumulation.

⁴ This, of course, is the author’s interpretation. The label neoliberalism is used to highlight that a mode of regulation is ultimately a *political* project. It is the outcome and institutionalization of various compromises and (in their intention often provisional) arrangements that acquire a certain degree of coherence. Within the framework of regulation theory the mode of regulation is comprised of the wage-labour relation, the forms of competition, the monetary regime, the forms of state intervention and the insertion into the international regime. This paper only sketches the changes in these areas, but clearly falls short of an exhaustive analysis.

Financial deregulation has two dimensions: liberalization of international capital flows and the deregulation of domestic financial systems. This led to fundamental changes in the financial landscape. At the international level capital flows were liberalized. Domestically changes in the financial framework gave rise to a rapid pace of financial innovation, eventually increasing the scope for speculation. Both developments strengthened the influence of the financial sector. Real interest rates rose well above the growth rates of real GDP. Financial ratios such as stock market capitalization, derivatives turnover or cross-border lending soared. Overall the income shares of financial capital increased considerably (Duménil and Lévy 2001, Power et al 2003). Moreover, the influence of financial investors on non-financial businesses has increased substantially under the so called shareholder value revolution (Lazonick and O'Sullivan 2000). These structural changes have been summarily called financialization and will play a key role in our analysis of the structure of accumulation (section 5). Globalization is a forth characteristic of the neoliberal mode of regulation. Its financial dimension, the liberalization of international capital flows, has already been mentioned. This was complemented by a free trade regime.

In continental Europe neoliberalism came, at least as far as economic policy is concerned, often in the guise of European integration and EU policies. In particular the free trade agreements of the Single European Act, competition policy, and, later the services directive reflect the liberal creed. The Maastricht Treaty and the Stability and Growth Pact were combined an anti-inflation priority with a restriction on fiscal policy without offering adjustment mechanisms for the imbalances that it gave rise to (see section 5.3).

The financial and economic crisis that began in 2007 has been a forceful reminder that free markets come with violent boom-bust cycles. By historical standards, government intervention has been relatively quick and extensive. This may suggest that neoliberalism has been abandoned. Such a conclusion interprets *neoliberalism* essentially as a *laissez-faire program*, a political project, which wants to do away with state regulation and state intervention. While this is certainly a tempting interpretation, and indeed warranted by some of the neoliberal rethoric, there are other interpretations as well. Harvey highlights a tension in neoliberalism: „We can (...) interpret neoliberalization either as a utopian project to realize a theoretical design for the reorganization of international capitalism or as a political project to re-establish the conditions for capital accumulation and to restore the power of economic elites“ (Harvey 203, 19). Indeed, *neoliberalism a project to restore class power* is a hallmark

of the Marxist interpretation of neoliberalism (e.g. Duménil und Lévy 2001, 2004). In this approach the anti-etatism of neoliberalism is instrumentalist, but not essential. It will be pursued when conducive to profitability, but not as an end in itself.

Already in the late 1970s Michel Foucault (2007) had suggested a third interpretation of neoliberalism, which we might call neoliberalism as form of *governance by competitive subjectification*. Based on a careful reading of the German ordo-liberal school and the US-American Chicago School Foucault argues that neoliberalism differs radically from classical liberalism in that it does not aim at liberating markets, but at *creating* markets and subordinating government activity under this goal. Markets don't create themselves, if left on their own, but have to be constructed and maintained. Contrary to classical liberalism neoliberalism thus requires permanent and profound state intervention. Stockhammer and Ramskogler (2009) reach a similar conclusion based on an analysis of recent economic policy and ('New Keynesian' and Neo-Institutionalist) developments in mainstream economics and call these developments '*enlightened neoliberalism*'. The title of the 2002 World Development report encapsulates this approach: *Creating Institutions for Markets*. As in the Marxist interpretation, state interventions do not constitute a break with neoliberalism.

Our approach in the following is cast in a regulationist framework⁵ and adopts a pragmatic concept of neoliberalism that points out that it came with changes in income distribution and a deregulation of the financial sector. This is hardly a deep analysis of neoliberalism, but it suffices the purpose of this paper, namely to highlight that several constituent components of neoliberalism are closely involved in the mechanisms generating the crisis.

4. Changes in income distribution

One of the hall marks of neoliberalism has been the polarization of the distribution of income. The shift in power from labour to capital is clearly reflected in wage developments. Wage shares have been falling across Europe and in Japan and, to a lesser extent, in the USA and

⁵ I am purposefully using the term regulationist 'framework' rather than regulationist 'theory' as the Regulation School, in my view, does not qualify as theory in the strong sense of the words, i.e. as positing specific causal relations that would explain a wide range of social (or economic) phenomena. Rather I regard it as a 'intermediate theory' that offers a platform to analyze historically specific eras by encompassing socio-institutional as well as economic aspects and allows potentially for the (historically specific) integration of (among others) Keynesian and Marxian arguments, as attempted in this paper. The theoretical scope of Regulation Theory, in this view, is limited; its practical usefulness, however, has been undervalued since its boom in the 1980s. In particular it is a pity that the analysis of power championed by the Social Structures of Accumulation approach, a close relative of the Regulation Theory has not inspired a broader research agenda.

the UK (see Figure 1). The Anglo-Saxon countries have, however, witnessed a strong increase of inequality in personal income distribution (Figure 2). Arguably, the exorbitant management salaries in the Anglo-Saxon countries should be considered a form of profits rather than wages. Indeed, subtracting the top 1% of wage earners from the US wage share, a strong decline can be observed. Based (CPI-adjusted) data available from OECD (2008), median weekly wages in the USA have grown by a mere 2.8% from 1980 to 2005, the bottom quartile of wages fell by 3.1% and the top10% increased by 21%.

Figure 1

Figure 2

Recently, mainstream economic policy institutions have shown a renewed interest in the determinants of *functional* income distribution. IMF (2007a) and EC (2007) conclude that technological change has been the main cause of the decline in the wage share and that globalization has been a secondary cause. In a panel analysis for OECD countries Stockhammer (2009) shows that the findings of these studies regarding technological change are not robust and that financial globalization, trade globalization and the decline in union density have been the main forces behind the falling wage share. The influence of globalization (of trade and production) and have been demonstrated in the mainstream literature (e.g. IMF 2007) as well as in the heterodox literature (e.g. Milberg and Winkler 2009 for the USA). ILO (2008) argues that financial globalization has contributed to the decline in the wage share, but does not provide econometric evidence. Rodrik (1998) and Harrison (2002) have included measures of capital controls and capital mobility. Remarkably, IMF (2007b) in a study on *personal* income distribution within countries finds that increases in foreign direct investment increases inequality.⁶ Onaran (2009) shows that financial crisis have long-lasting distributional effects for several developing countries.

What are the likely macroeconomic effects of this redistribution on aggregate demand? From a Kaleckian point of view, one would expect a dampening effect on aggregate demand. As wage incomes are typically associated with higher consumption propensities than profit incomes, this ought to lead to a decrease in the consumption share. Stockhammer et al. (2009)

⁶ FDI flows illustrate the difficulties in distinguishing between financial globalization and globalization in production.

find a saving differential of around 0.4 for the Euro area.⁷ Given that wage shares have declined by some 10 %-points since 1980, consumption shares ought to have declined by some 4% points (of GDP) over this period due to changes in income distribution. The background for macroeconomic developments in the neoliberal era is one of potentially stagnant demand.

5. The finance-dominated accumulation regime

Stockhammer (2008) suggests that since the early 1980 a neoliberal mode of regulation has emerged that is complemented by a finance-dominated accumulation regime. This section will explore the characteristics of the latter. The analysis of the macroeconomic structure will be guided by the standard Keynesian expenditure function. Aggregate expenditures consist of private consumption, investment, net exports, and government expenditures. Each of these components will be investigated to analyze whether changes that can plausibly be linked to financialization have occurred and modified the relevant behavioural pattern.

5.1 Investment

Given the rise in the profits, one might expect a dynamic growth of investment expenditures. However, this is what has happened. The disappointing performance of investment becomes most evident, when compared to profits (Figure 3). The decline in the investment-to-profits ratio can be observed in all major economies, even if the peak values differ across countries (the mean peaks in 1980). Financialization brought about several changes that potentially affect business investment (that is physical investment by firms). Admittedly, however, it has been hard to pin down these effects as business investment has always been the macroeconomic variable that is hardest to explain for economists. One of the most important changes in investment behaviour is due to the increased role of shareholders. Lazonick and O'Sullivan (2000) argue that a shift in management behaviour from 'retain and reinvest' to 'downsize and distribute' has occurred. More formally, Stockhammer (2004) shows that an increase in shareholder power will modify the desired profit-growth frontier for the firm. His estimation results suggest that financialization may explain a substantial part of the slowdown in accumulation. However, results vary widely across countries (strong effects in the USA and France, weak effects in Germany). Orhangazi (2008) finds evidence for this channel based on

⁷ This value is in line with comparable studies for other groups of countries (Naastepad and Storm 2006/07, Hein and Vogel 2008).

firm-level data for the USA. As the measure of operating surplus used in Figure 3 (as well as in the National Accounts) is a broad one that consists basically of all non-wage incomes, part of the reason for the declining trend in the investment operating surplus ratio is due to a change in the composition of the operating surplus. Interest and dividend payments have increased (Duménil and Lévy 2001, Crotty 2003). However only for few countries, namely for the USA, is data readily available. Onaran et al (2009) present econometric evidence for the negative effect of dividend and interest payments on investment.

Figure 3

A second change for investment behaviour has been in the economic environment that firms face. Volatility on financial markets has increased substantially in the course of financial deregulation. As a consequence firms face a higher degree of uncertainty which may make physical investment projects less attractive. In particular volatility of exchange rates seems to have had some effects on manufacturing investment. However, uncertainty is hard to measure and estimation results from the existing literature are not conclusive enough to suggest a clear order of magnitude of the effect (Carruth et al 2000, Stockhammer and Grafl 2008).

Overall financialization has had a dampening effect on business investment, probably due to negative effects of shareholder value orientation and increased uncertainty. Notably, there has been no renewed interest in the effect of share prices on business investment (quite in contrast to the research on consumption expenditures and share prices). As in the early 1990s (Chirinko 1993, Ford and Poret 1992), most empirical economists would probably agree that share prices have little, if any, effect on investment. Nor is there much evidence that other than in Ireland (and maybe in the Netherlands) residential investment has been strongly affected by rising household debt levels.

5.2 Consumption expenditures

There are two conflicting effects on consumption expenditures. First the deterioration of income distribution puts a downward pressure on consumption, because working class households have a higher consumption propensity than earners of capital income. The background for macroeconomic developments is one of potentially stagnant consumption

demand. Second, financialization has increased the access of households to credit. In combination with real estate booms this has often led to credit-financed consumption booms.

In the USA consumption expenditures have become the main driving force in GDP growth in the 1990s. Indeed, the consumption share in GDP had been increasing since about 1980 (see Figure 4). The trend is similar in the UK, but opposite in Germany and France. There consumption ratios have declined since 1980. There has been a remarkable divergence between countries. Mainstream economists try to explain this increase in consumption assuming rational behaviour (in Anglo-Saxon countries). The falling saving rates were first explained by a wealth effect due to the rise in the value of financial assets because of the stock market boom.⁸ In the late 1990s a 5% marginal propensity to consume out of financial wealth was often quoted (with some more qualification for European countries; e.g. Boone et al. 1998). The stock market crash in 2000, however, did not result in a slowdown in consumption growth. The unabated consumption boom in the USA was then explained by booming house prices. Residential property was now identified as the key source of the wealth effect as is more frequently accepted as collateral. Case et al (2001), Catte et al. (2004), and Girouard et al. (2006) find substantially higher marginal propensity to consume out of property wealth than out of financial assets.⁹

Figure 4

More generally speaking, financialization has given households more access to credit. Access to credit, of course, is not restricted to mortgages, but also includes other forms of consumer credit, credit cards and overdraft bank accounts. One of the key disagreements between the mainstream economics and heterodox approaches is the question whether people behave rationally. Much of the mainstream literature assumes that households rationally increased their debt ratios as their wealth increased. From a heterodox point of view a substantial part of the accumulated debt is due to households maintaining consumption levels that are unsustainable (and thus could be considered irrational). As wages have stagnated in many

⁸ Brenner (2003, 191) argues that most of the fall in the savings rate (in the late 1990s) occurred in the top income groups, who also benefited most from the increase in financial wealth. This, admittedly, fits uneasily with the argument made here. Evidence for the early 2000s, however, suggests that the debt burden has grown fastest for middle class households (which is in line with our argument) (State of Working America 2006/2007). This issue requires further research.

⁹ While there is substantial evidence for the USA (albeit based on a short period of observations!) to back up this story, the evidence on European economies was always much thinner. Typically the wealth effects estimated for European economies were not statistically significant and/or much smaller.

countries consumption norms as represented in mass media have arguably increased, many households could have been driven into debt (Cynamon and Fazzari 2009). From this perspective it is misleading to speak of wealth effect, it should rather be a *credit access effect*. Either way, in the USA, the UK, Ireland and Spain property bubbles were accompanied by strong increases in household debt ratios.

Household debt is difficult to measure and international comparisons chronically suffer from deficiencies in comparability of data due to different financial institutions and practices in different countries. Girourard et al. (2006) report a wide variation in household debt-to-income ratios. European countries display a wide range of debt to income ratios. However all European countries (for which data is available) have experienced rising debt ratios since 1995. Notably the (unweighted) average of the debt ratios of the European countries is similar to the USA.

OECD data also show that (household) savings rates are falling throughout the OECD countries, with the most pronounced fall occurring in the USA. Surprisingly, however, it turns out that this is not mirrored in the consumption data. While the USA (and Japan) have experienced a substantial and consistent increase of consumption compared to disposable income since the mid 1980s, the same is not true in Europe. In most countries, notably France and Germany, the changes in the consumption share are in the order of magnitude that are within the range of a business cycle. There was a strong increase in Greece and a strong decrease in Ireland. The (unweighted) average of the EU15 is unambiguously flat with no change in the consumption ratio of economic significance (Stockhammer 2008).

Overall, there is clear evidence for consumption as the driving force of growth only for few countries. The USA appears as the exception rather than the rule. Moreover, while household debt clearly increased in all countries, it did so to very different degrees, with the Anglo-Saxon countries (as well as Denmark and the Netherlands) showing the largest increases. European countries experienced a sharp decline in wage shares, which should translate into falling consumption. If so, increased debt may have compensated this decline even in continental Europe.¹⁰

¹⁰ There is an additional channel through which financialization may have affected consumption expenditures. In many countries the pay-as-you-go pension systems are being reformed or have been questioned. Typically some version of a capital-based system is envisioned in which households have to invest their savings (usually via funds) in the stock market. This should lead to an increase in savings as households have to put more aside for retirement. I am not aware that this channel has been investigated empirically.

5.3 Net exports and capital flows

Over longer periods net exports ought to be balanced. However, financial liberalization and globalization have allowed countries to sustain current account deficits at higher levels and for longer periods than previously. The flip side of the current account is net capital flows. (abstracting from changes in Central Bank reserves) net exports have to equal (net) capital outflows. Inversely, a current account deficit corresponds to capital inflows. Financialization has thus allowed countries to run larger current account deficits, provided that they can attract the corresponding capital inflows. Figure 5 plots the standard deviation of the current account as a ratio to GDP (for OECD countries) as a measure of international imbalances. This shows that international imbalances have increased substantially since the mid 1980s.¹¹ Two things are remarkable about Figure 5. First, imbalances in the early 2000s were above the levels of the mid 1970s when the oil price shock gave rise to strong changes in current accounts across many countries; second the rise in international imbalance has been gradually building up since 1980.

Figure 5

The imbalances in international trade have also played an important role as a precondition in the building up of the bubble in the USA. The corresponding capital flows have provided vast amounts of capital in search of yield in US\$ assets. These they found in various derivatives based on mortgage and commercial credit, thereby fuelling the credit-financed consumption boom. Without capital inflows the bubble in the USA would probably not have inflated as much as it did.

Financial liberalization and globalization have, ironically, increased the potential for different developments across countries – if only as long as international financial markets remain calm. However, the capital flows that underlie the trade imbalances may abruptly halt or reverse and thereby cause severe crisis. The macroeconomic dangers of volatile capital flows have so far been felt most acutely in emerging economies. Mexico 1994, Turkey 1994 and 2001, several countries in the course of the South East Asian crisis 1997/98, and Argentina

¹¹ As our measure only includes OECD countries China as well as some other South-East Asian countries that run substantial current account surpluses are not included. Our measure thus underestimates the full extent of international imbalances.

2001 are all examples of such crises related to capital flows. All of them have led to severe recessions (at times with double digit declines in real GDP), some of them long-lasting, others more short-lived.¹² However, the EMS crisis 1992/93 also shook developed economies (although the exchange rate devaluations were not as strong, nor were the following recessions).

The reason why changes in the exchange rate have such a devastating effect is that in liberalized international markets it is usually profitable to engage in interest arbitrage, that is borrow in one currency and invest or lend in another (often called carry trade). If, say, interest rates in Turkish Lira are higher than those in Euros (with exchange rates expected to be stable), it is tempting to take out a euro credit and lend in Turkish lira. By implication, assets and liabilities will then be denominated in different currencies (a related risk is that of the maturity of assets). Abrupt exchange rate realignments may then have disastrous effects on firms' or banks' balance sheets.

International exchange rate arrangements seem key to understanding the accumulation and growth dynamics in the finance-dominated accumulation regime. For Europe, the most important institutional change in this area of course was the EMS (which effectively ended with the 1992/93 crisis) and European Monetary Unification. The introduction of the Euro was a reaction to the EMS crisis, where several countries had to devalue their currencies by some 20% (vis à vis the Deutsch Mark). At first, the Euro appears to have been a success. Not only was the new currency accepted by the public, but the Euro system also eliminated (nominal) exchange rate fluctuations and thereby the possibility of exchange rate crises. It also substantially decreased inflation and (real) interest rates in the former soft-currency countries. However, since inflation differentials persist across European countries, there have been creeping changes in real exchange rates that have accumulated over the years. Real exchange rates have diverged since the introduction of the Euro.¹³ Germany has devalued by more than 20% in real terms vis a vis Portugal, Spain, Ireland or Greece since 1999. It is in this context the recent crisis around Greek government bonds has to be seen.

¹² The fact that some countries recover quickly after a deep recession, does not imply that everything returns to pro-crisis. Onaran (2009) argues that financial crises often lead to lasting changes in functional income distribution.

¹³ Presumably not all countries entered the Euro with the 'correct' exchange rate. In particular Deutsch Mark is often thought to have entered overvalued. However, if the real exchange rate realignments since 1999 were a correction of the initial values, one would expect the real exchange rates to stabilize after a while. As of now there is no indication for that.

The flaw of the Euro system is basically the following: There is a common monetary policy and fiscal policy is severely restricted. Exchange rate realignments are by definition not available to adjust divergences across the Euro zone. So how can countries adjust? Basically through wage moderation. But this fails to work in practise. First, labour markets simply are not as flexible as economic textbooks and EU treaties would like them to be. Second, the adjustment via labour markets has a clear deflationary bias – the country with the current account deficit will have to adjust and it has to adjust by wage restraint and disinflation. However, as overall inflation is limited to two percent, any country that seriously wants to improve competitiveness would have to go through an extended period of deflation, which would require mass unemployment and falling wages. The present model requires that the deficit countries restrain inflation and growth whereas the surplus countries are allowed to proceed running surpluses. But beyond its failure to deliver stability, this arrangement also has severe distributional consequences. Simply put, under the present arrangement Greek wages have fall, but German wages do not have to rise. The system puts a downward pressure on wages.

Europe has reacted to the liberalization of capital flows by introducing a common currency. While this has ended the risk of exchange rate crises, trade and cost-related imbalances have bee building up within the Euro area and there is no mechanism for resolving these imbalances.

5.4 The finance-dominated accumulation regime: fragile and low growth

While there is evidence for a consumption boom in the USA (and previously for limited periods in some developing countries), for continental European countries one does not find the strong evidence of a consumption boom (related with a property price bubble)– despite the fact that household debt levels increased substantially. However, given that income distribution has changed at the expense of labour, which should have decreased consumption ratios, it is plausible that debt-driven consumption has also fuelled demand in Europe to some extent.¹⁴ Investment performance has been weak. In particular rising profits have not translated into rising investment. Presumably (but hardly conclusively) this is related to shareholder value orientation and increased uncertainty due to volatile financial markets. The liberalization of capital flows has relaxed current account constraints on countries and led to

¹⁴ There is little evidence however, that this debt, much of which is mortgage debt, has caused a substantial increase in residential investment. The latter is falling as a share of overall investment.

volatile exchange rates, which however, have not translated into a severe crises in Europe (with the exception of the 1992/93 EMS crisis) as they did in South East Asia, Latin America or Turkey. The Euro system has effectively prevented currency crises. However, the Euro came with a policy package, the Maastricht Treaty and the Stability and Growth Pact, that has fostered neoliberalization within Europe and led to a creeping divergence within Europe.

Overall the effects of financialization thus give rise to a finance-dominated accumulation regime that is one of *slow* and *fragile* accumulation. There are two related reasons to expect the finance-dominated accumulation regime to come with more volatility in output growth (and other macroeconomic variables). First, macroeconomic shocks from the financial sector have become more severe and more frequent. There is ample evidence that financial markets generate highly volatile prices. Overshooting is well established for exchange rates and the boom bust cycles of share prices has become evident (again) in the past years. Second, because of high debt levels, the fragility of the economy has increased. Financialization has encouraged households to take on more debt. This debt presumably either has fuelled consumption expenditures or was necessary to buy property in the face of soaring house prices. Either way, debt has to be serviced out of current income (or by ever increasing debt). Even temporary reductions in income may thus escalate if households have to default on their loans. While this need not happen necessarily, the *fragility* of the system has increased as the resilience of households against temporary shocks has decreased.

One would expect that this combination of more frequent crises on financial markets and high fragility of households to translate into macro economic volatility. IMF (2007c) presents evidence that business cycle have become more *moderate* since the 1970s. The devil, however, lies in the detail. While “output volatility (...) has been significantly lower than during the 1960s” (IMF 2007c, 85), recessions have become harsher in the Post-Bretton Woods era than in the Bretton Woods era (IMF 2002, Table 3.1). As output growth (and expansions) was much higher in the Fordist era than in the post-Fordist era, the IMF is correct in concluding that volatility has decreased. But this does not mean that recession have become less severe! Moreover, financial crises have become more frequent and more severe (Eichengreen and Bordo 2003).¹⁵ The present crisis is not a rare exception, but only one of many in the age deregulated finance.

¹⁵ In particular Eichengreen and Bordo report that there had been *no* banking crises in the 1945-73 period.

It is important to note that state shares in GDP are still substantially higher than at the time of Great Depression. Automatic stabilizers are thus in place and government consumption forms a sizable part of value added. Moreover, central banks in developed countries (in particular the Fed) have been pro-active in reacting to dangers of financial crisis. The resilience of a sizable government sector and (by historical standards) a functional welfare state combined with adept monetary policy may be the reason, why financial crises have so far not had a devastating effect on (advanced) economies (Stockhammer 2008).

6. Income distribution and the underlying causes of the present crisis

Two of the main characteristics of neoliberalism are the polarization of income distribution and the deregulation of the financial system. Both have interacted in complex ways to provide the preconditions of the present crisis. The polarization of income distribution is closely linked to the international imbalances that underlie the present crisis. The median working class household has experienced stagnant wages in most developed countries. Certainly consumption norms (as spread through mass media) have increased faster than median wages. Combined with a weak investment performance this has led to shortfall of private demand. Effectively (but not necessarily by intention) two different strategies have emerged: In Anglo-Saxon countries the shortfall of disposable income has been compensated by credit and increasing debt levels. The property boom allowed households to take out loans that they could not afford given their income, but that seemed reasonable to banks which assumed that property prices would continue to increase. These countries developed a *credit-financed consumption boom* that came with current account deficits. The resulting capital inflows again fuelled the property bubble and bubbles in other financial markets.

In the second group of countries median working-class households faced a similar stagnation in wages. In these countries private consumption expenditures remained weak. Here net exports played the key component of demand growth. Thus these countries developed an *export-led growth model*.

The same phenomenon, stagnation in real wages, had different effects in different countries. Moreover, the two growth models rely on each other: the credit-driven consumption model implies current account deficits and thus will only work, if there are surplus countries. Inversely, the export-growth strategy will only work, if there are deficit countries that absorb

their exports. The current account imbalances were made possible by financial globalization and the liberalization of capital flows.

The roots of the crisis are thus only in part to be found in the financial sector. Given the severity of the economic crisis it is tempting to infer that it must have profound structural roots. Our analysis suggests that this is indeed the case. All building blocks of neoliberalism - financialization, rising inequality and globalization – are implicated in giving rise to creating the imbalances that have erupted in the present crisis. In this sense it is very much *a crisis of neoliberalism*.

This diagnosis is not to be confused with forecasting the imminent demise of neoliberalism., even if the stocks of free market ideology have suffered from some time to come. The Marxist as well as the Foucault'ian interpretation indicate that neoliberalism is about power relations (or governmentality) rather than about free markets. Looking at the policy debates in the aftermath of the crisis, the absence of a serious attempt to regulate finance, to reluctance of governments to use nationalized banks for industrial policy, the persistent taboo of increasing taxation of the super-rich that neoliberalism has created and the severe cuts in public services that look likely to follow the fiscal crisis can only conclude that in a political sense this *not* a crisis of neoliberalism.

7. Conclusion

The paper has argued that the causes of the present crisis are deeply rooted in neoliberalism. The polarization of income distribution and the deregulation of finance have interacted to create macroeconomic imbalances and bubbles. Highlighting the role of wage moderation in this process also lends itself to policy conclusions: As wage moderation has been one of the structural causes underlying the present crisis, one condition for re-establishing a viable growth regime, is a change in wage policy. Wages have to increase at least with productivity growth. This would stabilize domestic demand in the surplus countries and allow to avoid a collapse of consumption demand in the deficit countries. A more egalitarian income distribution is not luxury that can be dealt with once the economy has been stabilized, it is an integral part of a sound macroeconomic structure.

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Figure 1



Source: AMECO¹⁶

¹⁶ http://ec.europa.eu/economy_finance/db_indicators/ameco/index_en.htm

Figure 2.1 Income share of the top 1% in English-speaking countries

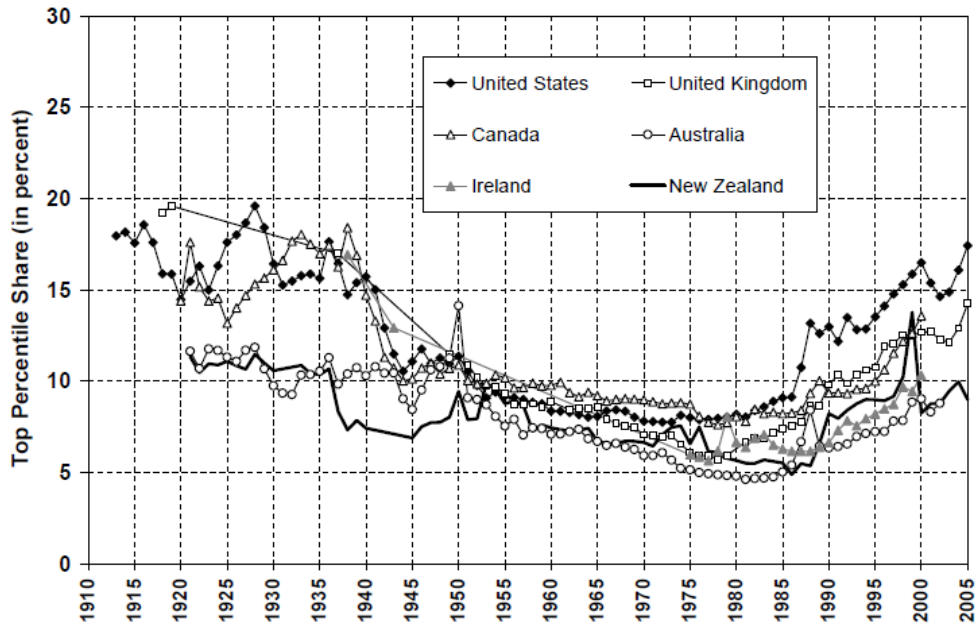
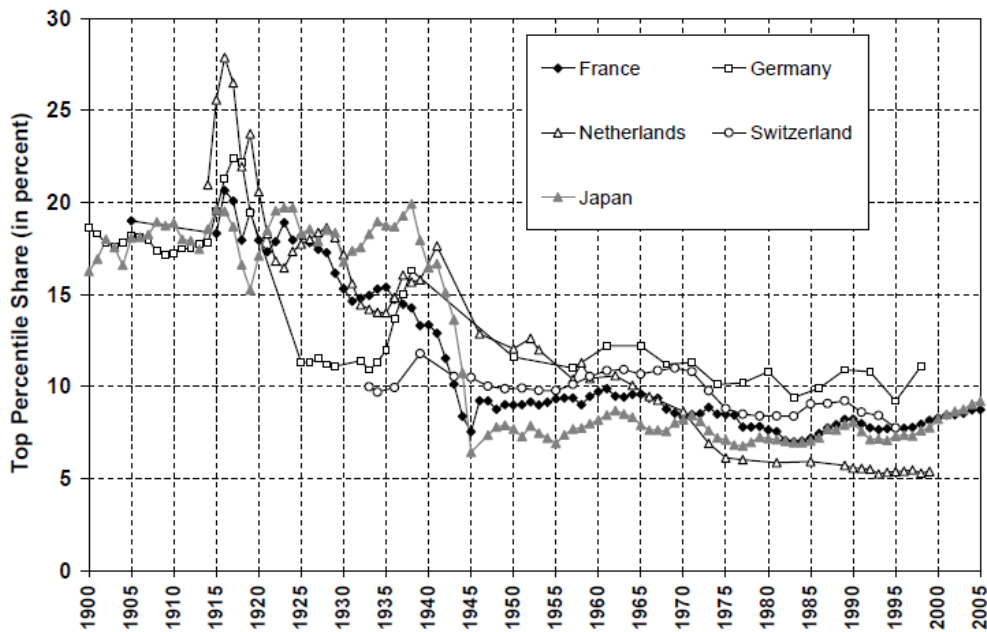
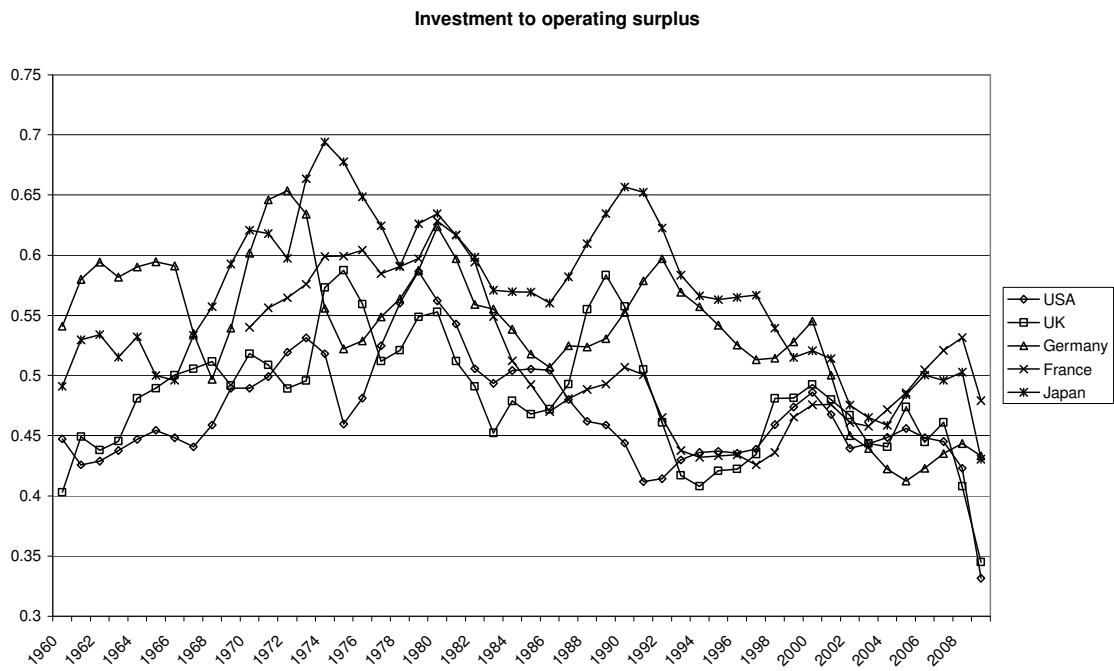


Figure 2.1 Income share of the top 1% in continental Europe and Japan



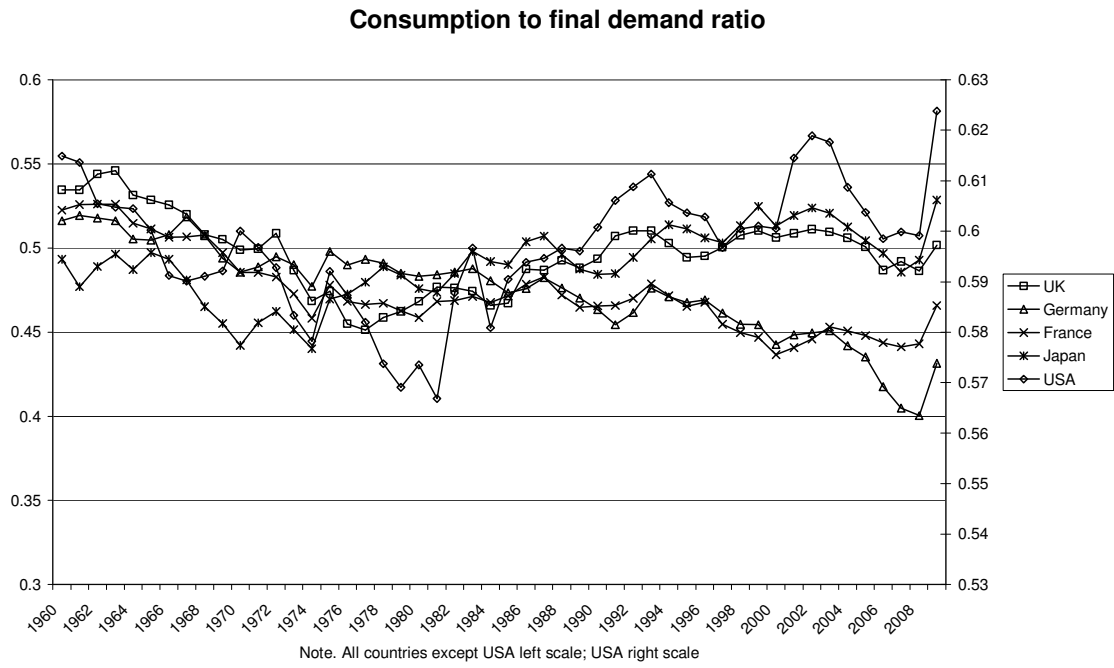
Source: Atkinson, Piketty and Saez (2010), Figures 7A and 7B

Figure 3



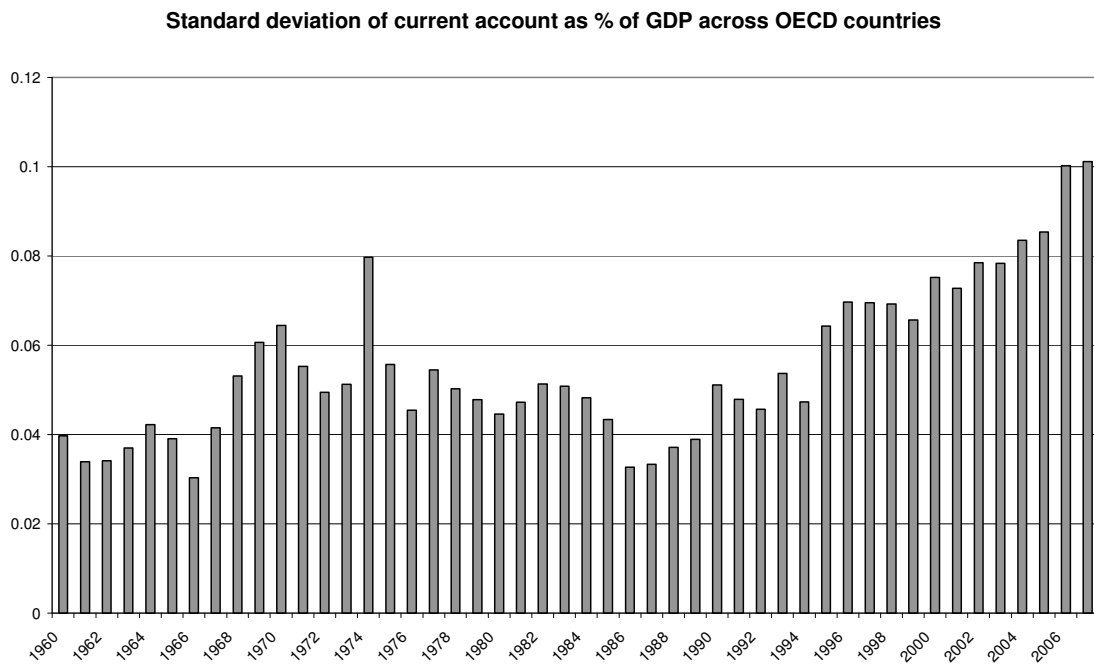
Source: AMECO

Figure 4



Source: AMECO

Figure 5. Standard deviation of the current account as % of GDP across OECD countries



Source: AMECO