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Hein, Eckhard and Truger, Achim

Institute for International Political Economy, Berlin School of Economics and Law

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Authors: Eckhard Hein and Achim Truger

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Finance-dominated capitalism in crisis – the case for a Global Keynesian New Deal[*]

Eckhard Hein[#] and Achim Truger[##]

[#] Berlin School of Economics and Law and Institute for International Political Economy (IPE) Berlin, Germany

[##] Macroeconomic Policy Institute (IMK) at Hans Boeckler Foundation, Duesseldorf, Germany

Abstract

We analyse the long-run imbalances of finance-dominated capitalism underlying the present crisis – which began in 2007 – with a focus on developments in the US and Germany. We argue that beyond inefficient regulation of the financial sector, the severeness of the present crisis has been mainly caused by increasing inequalities of income distribution and rising imbalances in the world economy associated with finance-dominated capitalism. From this it follows that in the near and not so near future, the US will no longer be able to act as the driving force for world demand. In order to avoid a period of deflationary stagnation in major parts of the world economy, we finally propose the policy package of a Global Keynesian New Deal which should consist of: 1. re-regulation of the financial sector, 2. re-orientation of macroeconomic policies along (Post-)Keynesian lines, and 3. re-construction of international macroeconomic policy co-ordination, in particular on the European level, and a new world financial order.

JEL code: E32, E44, E61, E63, E65

Keywords: Finance-dominated capitalism, financial crisis, macroeconomic policies, Global Keynesian New Deal

Corresponding author:

Prof. Dr. Eckhard Hein
Berlin School of Economics and Law
Badensche Str. 50-51
10825 Berlin
Germany
e-mail: eckhard.hein@hwr-berlin.de

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1. Introduction

The world economy is currently facing its most severe crisis since the Great Depression, which started in 1929 and lasted until the mid 1930s. On the one hand, this crisis is a financial crisis which started with the collapse of the subprime mortgage market in the US in summer 2007, and which gained momentum with the breakdown of Lehman Brothers in September 2008. Under the conditions of deregulated and liberalised international financial markets this financial crisis has rapidly spread all over the world. On the other hand, this crisis is a real crisis, which started well before the financial crisis, with an economic downswing in the US. The financial crisis and the real crisis have reinforced each other, and the world economy has been hit by a decline in real GDP in 2009 – something not seen for generations.[1]

The breakdown of the world economy could be halted by monetary policy interventions providing liquidity on a massive scale to the money market, thus preventing a meltdown of the financial sector, and, in particular, by massive fiscal expenditure programmes. We will argue, however, that the present global crisis, with serious future deflationary risks, marks a structural break in long-run development since the early 1980s. This development has been dominated by the neo-liberal model of deregulated labour markets, reduction of government intervention and social policies, redistribution of income from (lower) wages to profits and high management salaries, and deregulated international financial markets. In the US and the UK this model, in combination with expansive monetary and partly fiscal policies, has been able to generate sustained periods of high growth rates and low unemployment, and these economies performed far better than the Euro area and, in particular, Germany as the largest Euro area economy.[2] The neo-liberal model has also been consistent with a long period of sustained growth of the world economy, with the US as the demand locomotive until recently. However, as the crisis has made clear, this model has been built on considerable imbalances, both at the national and the international level.

In Section 2 of this paper we will analyse the long-run imbalances associated with the neo-liberal model of finance-dominated capitalism underlying the present crisis. We will focus on developments in the US and Germany as two representative countries of these

[1] The IMF (2010) reports the following GDP growth rates for 2009: world output: -0.8 per cent; USA: -2.5 per cent; Euro area: -3.9 per cent; Germany: -4.8 per cent; France: -2.3 per cent; Italy: -4.8 per cent; Spain: -3.6 per cent; Japan: -5.3 per cent; UK: -4.8 per cent; Russia: -9.0 per cent; Brazil: -0.4 per cent. Among the major countries, only in China (+8.7 per cent) and India (+5.6 per cent) GDP growth did not become negative in 2009, although these countries also experienced a remarkable decline in growth.

[2] See Hein/Niechoj (2007) and Hein/Truger (2005a,b, 2007a,b,c, 2009) for comparisons of the more restrictive German and Euro area macroeconomic policies, with the more expansive versions pursued in the US and the UK. These differences in the chosen macroeconomic policy mixes contribute to the differences in GDP growth and unemployment since the mid 1990s, and in particular since the recession in 2000/01.

imbalances. As a result of this analysis we argue that, in both the short and the long run, the US will no longer be able to act as the driver of world demand. This will have major implications for economic policies far beyond immediate responses to the crisis, in particular for those countries which have benefitted from soaring US demand in the past – i.e. the countries with huge current account surpluses, in particular China, Japan and Germany. Against this background, Section 3 will provide a brief review of the short-run economic policy reactions towards the crisis, and will outline some perspectives for future development. In Section 4 the long-run requirements for economic policies preventing sustained deflationary depression in major parts of the world will be described, and the components of a Global Keynesian New Deal will be outlined. We will argue that a Global Keynesian New Deal will have to tackle the three main sources of the present crisis: the inefficient regulation of financial markets, increasing inequalities in income distribution, and imbalances in the current accounts at a global scale. Section 5 will conclude.

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

The present crisis is often seen as a consequence of liberalised financial markets, wrong incentives, personal greed, fraud, naïve beliefs, and herding behaviour by economic actors, which have given rise to housing price bubbles, and their subsequent bursting.[3] It is certainly true that on the one hand inefficient regulation of financial markets is an important source of the present crisis. But on the other hand, there are at least two further sources: increasing inequalities in income distribution and imbalances in the current accounts at the global scale.[4] We will focus on these causes, which have developed in the US, where an increasing financial market orientation began in the early 1980s, and which has fed world-wide imbalances since then.[5] Although the term 'financialisation' – often used in this context – has many facets,[6] from a macroeconomic perspective we prefer to see financial market orientation and 'financialisation' through the lenses of the effects on income distribution, consumption and

[3] See, in particular the overview in Akerlof/Shiller (2009: 29-40, 149-156), but also Baker (2009).

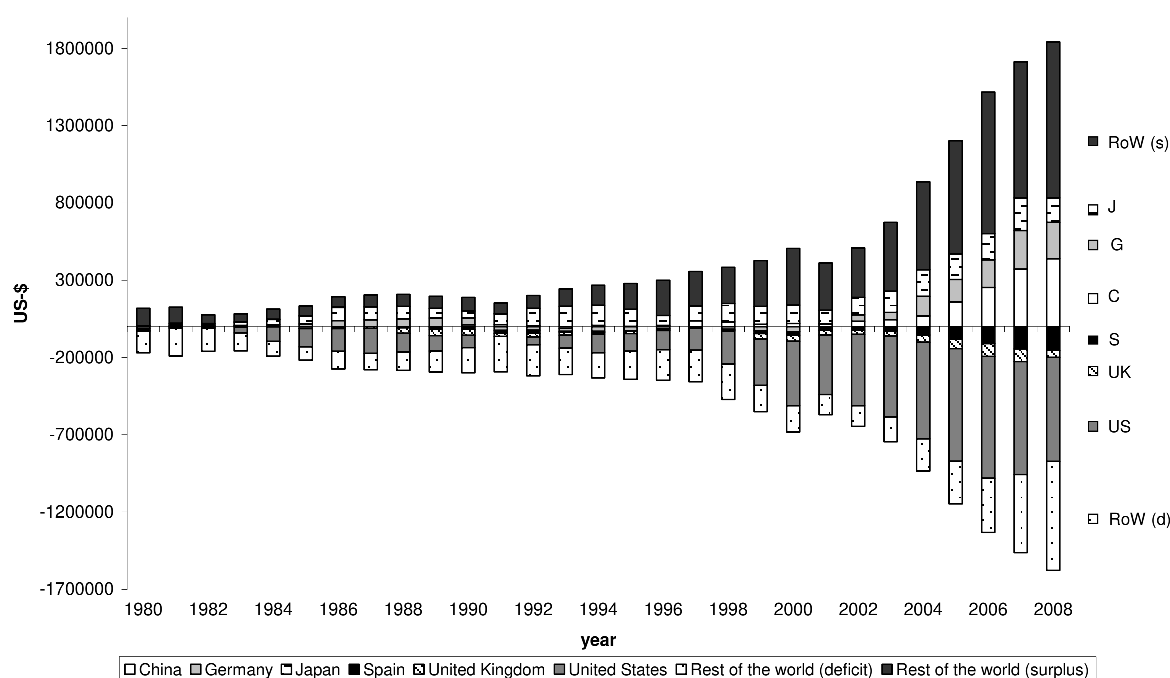
[4] On global imbalances and unequal distribution as causes for the present crisis see also, with different emphasis, Bibow (2008), Horn et al. (2009), Fitoussi/Stiglitz (2009), Sapir (2009), UNCTAD (2009), and Wade (2009). In particular, see also the early pre-crisis analysis by van Treeck/Hein/Dünhaupt (2007) focussing on the effects of 'financialisation' on distribution, aggregated demand, global imbalances and the following potential for instability.

[5] See Guttmann (2009) for a review of the changes in world wide financial markets and related imbalances which fed the financial crisis.

[6] Epstein (2005: 3), for example, argues that '[…] financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'.

investment (Hein 2009, 2010, Hein/van Treeck 2010). From this perspective, we will briefly sketch the long-run development up to the present crisis in the US, on the one hand, and in Germany, on the other.[7] The US and Germany can be seen as two main representatives of the global current account imbalances, the US being the primary deficit country and Germany – together with China, Japan and the oil producing countries – being one of the main surplus countries.[8] As can be seen in Figure 1, these imbalances have exploded, in particular, since the early 2000s when the recovery from the New Economy crisis began.

Figure 1: Current account balances, 1980 – 2008, in millions US-$



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

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

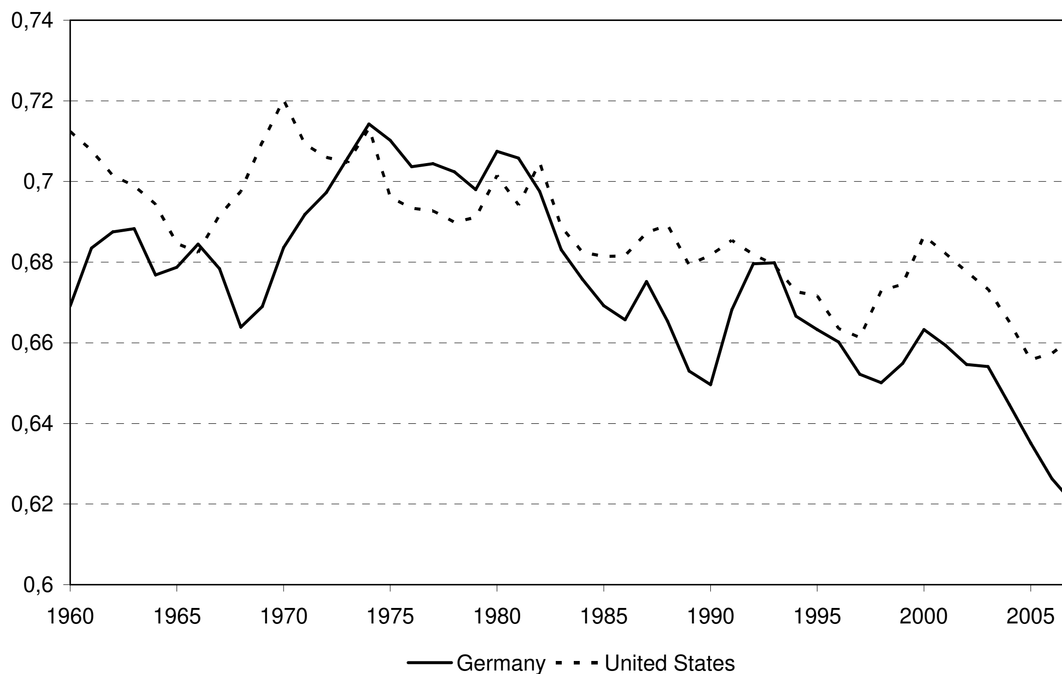
Increasing financial-market orientation in the US since the early 1980s has been associated with considerable redistribution. On the one hand, high unemployment, anti-labour policies, increasing shareholder value orientation of management, induced by stock-market oriented

[7] See Krippner (2005), Palley (2008), and the contributions in Epstein (2005) for a detailed treatment of the development of 'financialisation' in the US, van Treeck (2009a) and van Treeck/Hein/Dünhaupt (2007) for a more detailed comparison of the macroeconomics of 'financialisation' in the US and Germany, and Stockhammer (2008) for the development in Europe.

[8] Of course, there are major differences among the surplus countries. Whereas current account surpluses in China were accompanied by high growth rates, in Germany and Japan they were accompanied by mediocre growth and longer periods of stagnation, in particular in the 1990s (Japan) and the early 2000s (Germany).

remuneration schemes and a market for corporate control favouring a policy of 'downsize and distribute' in order to keep stock prices high instead of Fordist/Golden Age type 'retain and invest' (Lazonick/O'Sullivan 2000) have increased pressure on workers' and trade unions' wage demands and have contributed to the tendency of the wage share to fall, which had already started in the early 1970s (Figure 2).[9] On the other hand, inequality in income has increased remarkably to a level not seen since the 1920s, mainly due to increases in top-management salaries (Piketty/Saez (2003, 2006) (Figure 3).

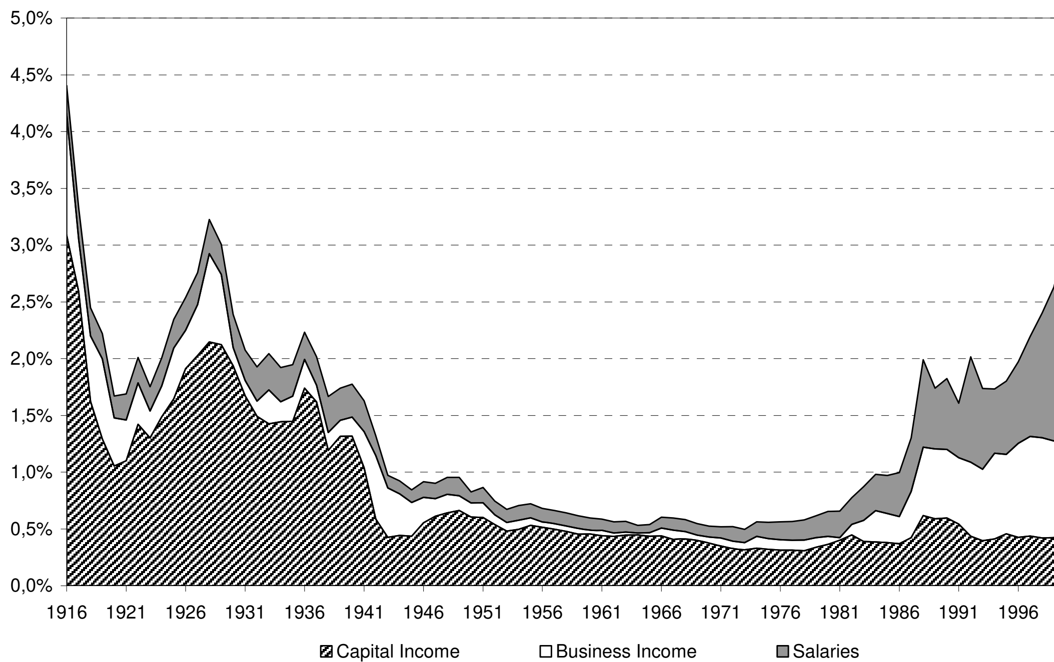
Figure 2: Labour income share in per cent of GDP at factor costs in the US and Germany, 1960-2007



Source: AMECO Database of European Commission.

[9] For studies on the effects of increasing shareholder or rentier power on income shares see Dumenil/Levy (2005), Epstein/Power (2003) and Epstein/Jayadev (2005).

Figure 3: The top-0.01 per cent income share and composition in the USA, 1916-2000

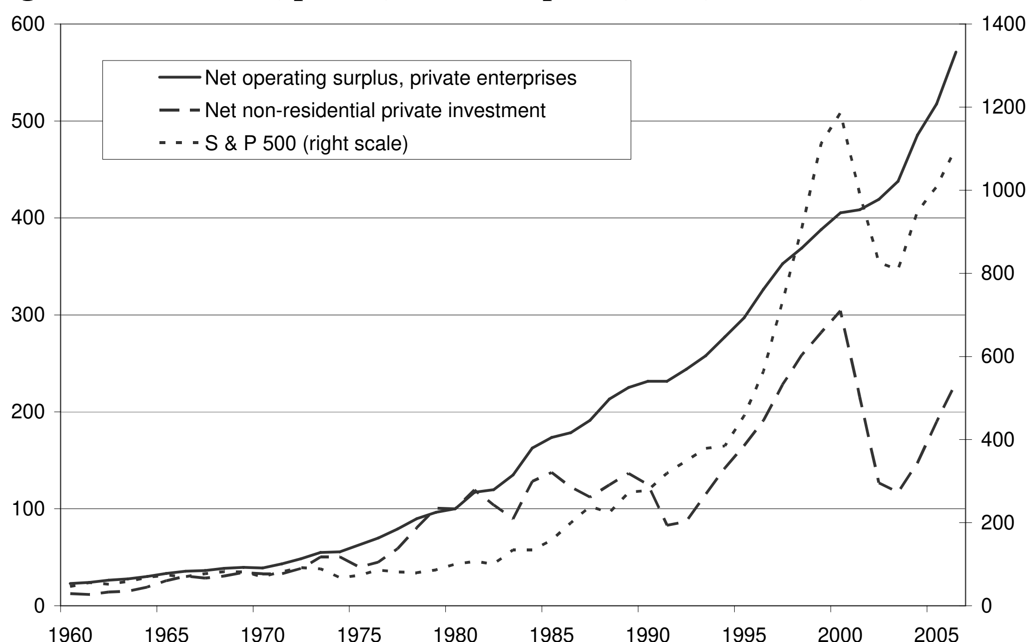


Source: Piketty/Saez (2006).

Against the background of these trends in re-distribution, real investment in the business sector remained weak, with the exception of the New Economy boom in the second half of the 1990s. Since the early 1980s, a decoupling of the development of investment and profits can be observed, accompanied by a dynamic increase in share prices until the New Economy bubble burst in 2000 (Figure 4). Two features of 'financialisation' have contributed to the weak tendency of real investment: First, the rising dominance of shareholders vis-à-vis management changed the preferences of the firm as a whole: short-term maximisation of shareholder value via distribution of profits and share buybacks was favoured, compared to real investment projects which promised only long-term gains ('preference channel'). Second, increasing dividend payouts and share buybacks in order to keep share prices high – and to prevent hostile takeovers etc. – reduced internal means of finance for real investment projects ('internal means of finance channel').[10]

[10] For the effects of increasing shareholder power on investment see Crotty (1990) and Stockhammer (2005-6)), and for empirical evidence regarding the negative effects of 'financialisation' on real investment via the 'preference channel' and the 'internal means of finance channel' see the estimations by Orhangazi (2008), Stockhammer (2004) and van Treeck (2008). For theoretical modelling within Post-Keynesian distribution and growth models, see Hein (2009, 2010), Lavoie (2008), Skott/Ryoo (2008a, 2008b), van Treeck (2009a) and the overview in Hein/van Treeck (2010).

Figure 4: Investment, profits, and share prices, USA, 1960-2006, 1980 = 100



Source: van Treeck (2009a), Data are from NIPA, table 1.10; Fixed Assets Tables, table 5.9; author's calculations.

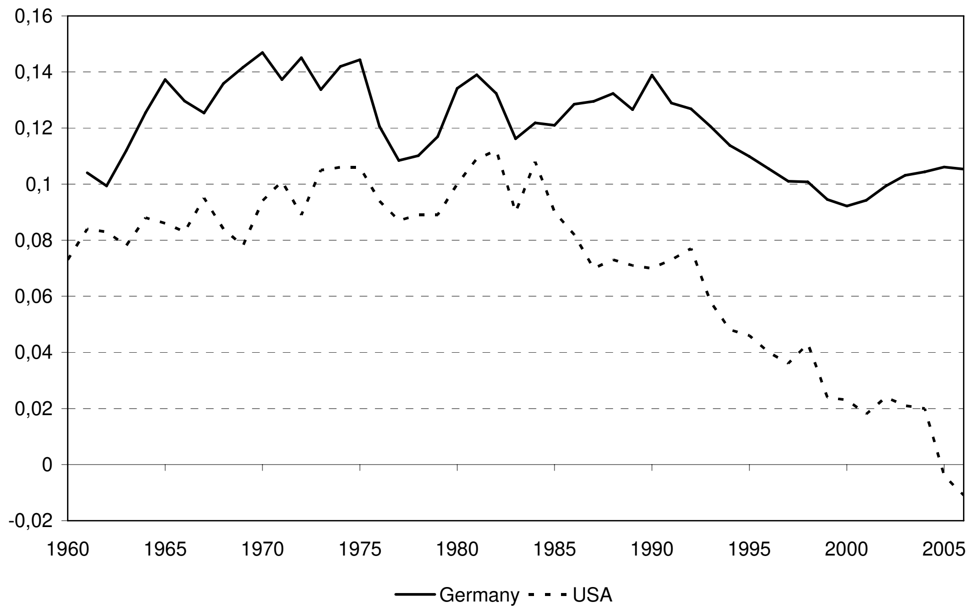
A macroeconomic constellation of 'profits without investment' (Cordonnier 2006) as in the US since the early 1980s, however, can only arise if weak investment is compensated for by high consumption out of profits or wages, by a high public budget deficit, or by a high current account surplus (Kalecki 1954: 45-52). In the US, rising profits in the face of weak investment were generated by soaring private consumption. Since the early 1980s relatively high growth, by international standards, was mainly driven by private consumption expenditure. The growth contribution of private investment diminished – with the exception of the New Economy boom – and the growth contribution of net exports has been negative since the mid 1990s (van Treeck 2009a). In recessions, government deficits up to 6 per cent of GDP stabilised GDP growth and hence profits (Hein/Truger 2007a).

In the face of weak real wage growth, dynamic consumption demand meant a decreasing propensity to save out of current income, and increasing households' indebtedness (Figure 5).[11] The stock market boom in the second half of the 1990s, followed by the house price boom until the recent crisis, (seemingly) generated collateral against which households could borrow. Liberalised credit standards and the trend towards securitisation ('originate and distribute') decreased creditworthiness standards and allowed for increasing household debt.

[11] See Barba/Pivetti (2009) on increasing household debt as the result of redistribution of income and rising inequality. For a theoretical assessment of the potentially contradictory effects of household debt on macroeconomic dynamics see Bhaduri/Laski/Riese (2006), Dutt (2006) and Palley (1994).

The boom of property-based and credit-financed consumption was driven by rich households first, but then low income households followed this pattern, too (Joint Centre of Housing Studies 2006). When housing prices stopped rising in the face of increasing interest rates, the subprime mortgage market – covering mortgages to low income and low wealth households – triggered the present crisis.

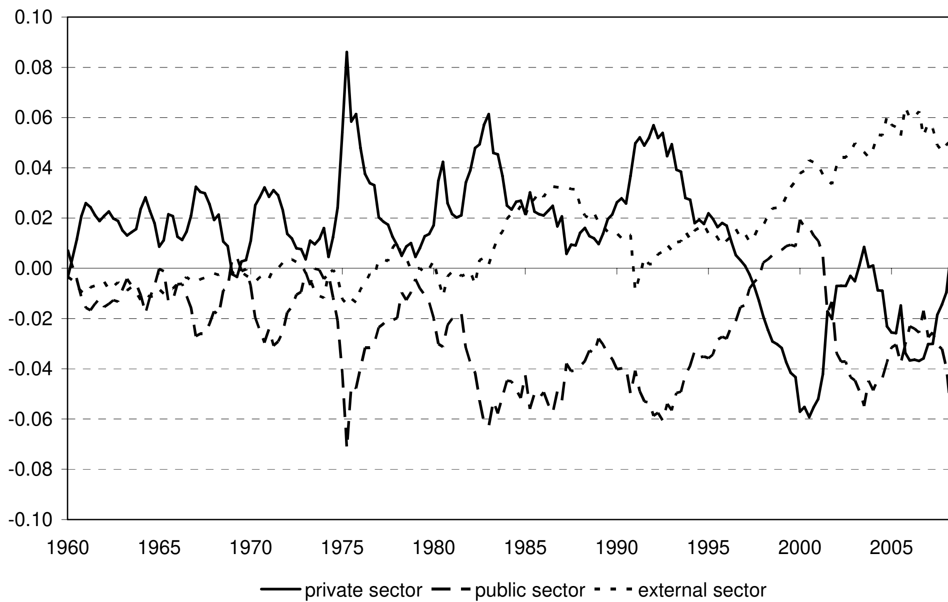
Figure 5: Saving rate of private households in Germany and the US, 1960-2006



Sources: OECD Economic Outlook Database; NIPA; authors' calculations.

Taken together, below the surface of a seemingly robust and dynamic development in the US since the early 1980s, major imbalances have been generated, which are responsible for the severe present crisis spreading all over the world. Figure 6 shows these imbalances using sectoral financial balances as a share of nominal GDP, which by definition have to sum up to zero. In particular, with weak private investment after the collapse of the New Economy boom, the private sector balance nonetheless turned negative due to the debt-financed consumption boom. The financial balance of the state also turned negative because of counter-cyclical fiscal policies. Consequently, the balance of the rest of the world had to be positive: High and rising current account deficits meant increasing capital imports financing the US-consumption boom and government deficits.

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



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

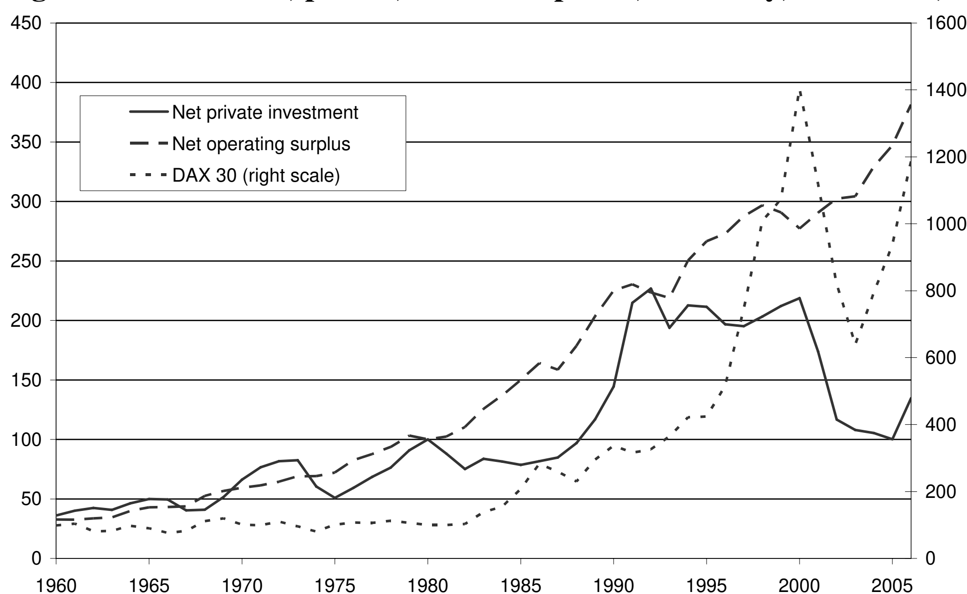
Such a constellation is highly fragile, because domestically it has to rely on ever rising property prices in order to allow for rising indebtedness fuelling steady increases in consumption demand under the conditions of a low labour income share and high inequality in household incomes. Regarding the relationship with the rest of the world, a sharp depreciation of the US-dollar, which would have been required in order to improve international price competitiveness of US producers and thus the current account, had to be prevented in order to guarantee steady capital imports without having to raise domestic interest rates, which in turn would have increased the possibility of a collapse in the domestic demand boom. When such a constellation erodes – as in the aftermath of the subprime mortgage crisis and the following downswing – not only the US is affected, but also the rest of the world. In particular, the surplus countries have to suffer twofold. On the one hand, capital exports into highly speculative US markets associated with their current account surpluses are devalued by the financial crisis, and therefore the financial crisis quickly infects the surplus countries. On the other hand, their markets for exports collapse and they are thus infected by the real crisis, too.[12]

[12] The economic downturn in 2009 in the slowly growing surplus countries, in particular Germany (-4.8 per cent) and Japan (-5.3 per cent), was even more severe than in the US (-2.5 per cent) where the crisis started (IMF 2010).

2.2 Dysfunctional mercantilism in Germany – a counterpart to the US development

Against the background of a falling labour income share since the early 1980s (Figure 2) and increasing inequality in household income during the 1990s (Bach/Corneo/Steiner 2007, OECD 2008), economic development in Germany has also been dominated by a decoupling of profits and private investment in capital stock since the early 1980s, which was only interrupted by the unification boom in the first half of the 1990s (Figure 6). This can be attributed to increasing financial market orientation for the development since the mid 1990s, because major steps towards the liberalisation and deregulation of financial markets took effect in this period: in 1991 the abolition of the stock exchange tax, in 1998 the legalisation of share buybacks, in 2002 the abolition of capital gains taxes for corporations, and in 2004 the legalisation of hedge funds.

Figure 7: Investment, profits, and share prices, Germany, 1960-2006, 1980 = 100



Source: van Treeck (2009a), Data from AMECO; Ecowin; author's calculations.

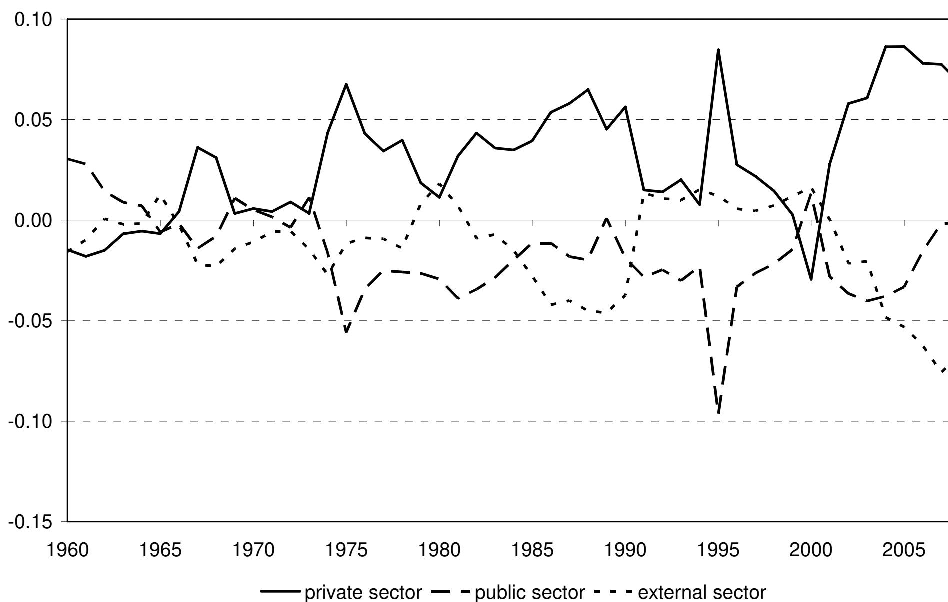
As we have analysed elsewhere in more detail, restrictive macroeconomic policies and weak domestic demand have contributed significantly to weak investment, hence the weak growth and employment performance in Germany since the middle of the 1990s, and in particular after the 2000/01 recession (Hein/Truger 2005a, 2007a, 2009). Increasing uncertainty, caused by policies of 'structural reforms' and deregulation in the labour market (Agenda 2010 and Hartz-laws), subsidies for capital based private pension schemes ('Riester-' and 'Rürup' pensions), and redistribution at the expense of (low) labour income and in favour of profits and high income receivers associated with nominal wage moderation, have led to an increase

in the propensity to save of private households since 2001, contributing to weak consumption demand (Figure 5). Pressures on trade unions caused moderate wage increases and contributed to inflation rates below the Euro area average, leading to above average real interest rates. This made Germany particularly vulnerable to restrictive monetary policies by the European Central Bank (ECB). And the attempts of fiscal policies to balance the budget, by means of expenditure cuts in periods of weak private demand, have reinforced weak domestic demand without reaching the consolidation target.

As the only driving force of mediocre growth there remained high and increasing export surpluses. The degree of openness of the German economy increased significantly: In 1995 the ratio of nominal exports to nominal GDP was 24 per cent, but it increased to 47.3 per cent in 2008. Current account surpluses quickly reached more than 4 per cent in the years after the recession 2000/01, peaking at 7.9 per cent of GDP in 2007. The reasons for rising net exports were extreme wage moderation, on the one hand, which increased the price competitiveness of German producers in international markets, and low domestic demand making imports fall short of rising exports, on the other hand.

As can be seen from the sectoral financial balances – each in relation to nominal GDP – in Figure 8, Germany has been a counterpart to the US development, in particular since the 2000/01 recession. Weak investment was not compensated by strong private consumption, and the private financial balance was thus strongly positive. High and rising German current account surpluses, and hence a negative financial balance of the rest of the world, acted as a stabiliser for weak domestic economic activity and profits. The government's financial balance has remained negative since the early 1990s. One major difference from the US, however, was that government deficits were not the result of active and expansive fiscal policies, but the macroeconomic result of restrictive fiscal policies in a period of slow growth (Hein/Truger 2009).

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



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

Whereas the dynamic consumption-driven model of the US had to rely on the willingness and the ability of private households to go into debt – and of the rest of the world to supply credit –, the stagnating German neo-mercantilist model had to rely on the willingness and the ability of the rest of the world to go into debt. Contrary to public opinion before the crisis, this German model has been as fragile as the US model. On the one hand, the moderate growth rates were dependent on the dynamic growth of export markets, and hence on expansion of the world economy. On the other hand, increasing capital exports to the more dynamic economies carried the risk of contagion in the case of a financial crisis in these markets. And both channels became effective during the present crisis.

3. Economic policy reactions in the crisis and perspectives for development[13]

The global financial and real economic crisis has led to remarkably fast and strong economic policy reactions in many countries (OECD 2009). As an immediate measure central banks have provided massive liquidity to money markets thereby meeting their lender of last resort function. In many cases the financial sector had to be bailed out in order to prevent a breakdown of the whole financial system. And to differing extents in different economies monetary policy and fiscal policy switched to expansion in order to tackle the crisis of the real

[13] For a more detailed analysis of the short-run macroeconomic policy reactions towards the crisis see our companion paper (Hein/Truger 2010).

economy. Although many details of the measures chosen may be open to criticism, it cannot be doubted that the general direction of most of the measures was appropriate.

From the point of view of the current paper, however, the crucial question is, whether the macroeconomic policy measures taken also address the long-run inequalities and imbalances of finance-dominated capitalism. If they don't, the major causes of the current crisis will still be in place after the crisis, which in turn will mean that the future prospects for sustainable and prosperous development of the world economy will be harmed. As the following short analysis reveals, unfortunately, at least for the two important economies in the focus of the current paper, the U.S. and Germany – and with it the Euro area – no significant change in the general economic policy patterns is discernible yet.

The recession in Germany was considerably stronger than in the US, where the crisis originated. In 2009 annual real GDP fell by 4.8 per cent in Germany, but only by 2.5 per cent in the US (IMF 2010). The major reason for this was that Germany, as a neo-mercantilist economy mainly driven by export demand, was particularly hard hit by the global slowdown and dramatically falling export demand.

Regarding macroeconomic policy reaction, interest rate policies by the respective central banks have shown a similar pattern as in the recession 2000/01 (Hein/Truger 2007c). Whereas the Federal Reserve started to lower interest rates quickly and drastically from 5.25 per cent in the second half of 2007 to 0.25 per cent in early 2009, the European Central Bank (ECB) followed its "wait and see" stance it had already shown in the previous recession. In July 2008, when the dramatic economic slowdown could be ignored no longer, the ECB even increased the key interest rate by 25 basis points to 4.25 per cent with recourse to inflationary dangers. However, it was clear that the strong increase of the HICP since autumn 2007 was almost entirely due to the rise of oil prices. There were no clear signs of second round effects, because nominal unit labour cost growth remained moderate. The ECB only started to lower interest rates in late 2008 when the recession took effect, and oil prices – and consequently the HICP growth – had started to fall. In 2009 the main refinancing rate finally came down to 1 per cent where it has remained since then.

Regarding fiscal policies, we have seen quick and massive discretionary reaction in the US with an expansionary package of close to 6 per cent of GDP for the period 2008-2010, according to the estimates of the OECD (2009). Unlike in previous recessions (Hein/Truger 2007a) fiscal policy in Germany has also reacted in a remarkably counter-cyclical way to the crisis. After some hesitation and some merely 'cosmetic' measures in the first months of 2009 a substantial stimulus package was enacted. Overall the expansive discretionary fiscal policy

stance amounts to 1.5 per cent of GDP in 2009 and 1.0 per cent in 2010 (OECD 2009). Compared to the usual German fiscal policy reaction which used to be pro-cyclically restrictive in times of crises, this is certainly a remarkable progress. However, there are two drawbacks: First of all, both the discretionary reaction and the overall impact of the US fiscal policies have again been stronger. Second, as a political precondition to the German stimulus package, a so-called ‘debt brake’ was written into the constitution which will limit the room of manoeuvre for German fiscal policy in the future and will set it on a restrictive consolidation path irrespective of the economic situation from 2011 onwards.

Regarding wage policies and unit labour cost development as a major determinant of prices and inflation, there is a serious threat of deflation in the two countries under consideration. Weak labour unions and the increasing (threat of) unemployment have imposed downward pressure on the growth of compensation of employees in the US, and with acceleration of productivity growth in the course of recovery this will generate negative nominal unit labour cost growth and hence a deflationary pressure in the future (European Commission 2009). Although unemployment has been remarkably stable in Germany since the beginning of the crisis, in particular German wage development remains a major source of concern. Since the end of the 1990s it has almost consistently undercut Euro area wage developments and is expected to continue to do so over the next years (Hein/Schulten/Truger 2006, European Commission 2009). In a fragile economic situation as the current this will exert a substantial downward pressure on wages in the other Euro area countries and it carries with it a high risk of deflation for Germany and the Euro area as a whole. The unit labour cost growth rate in 2010 is already expected to be negative both in Germany and the Euro area. If fiscal and monetary policy stimuli are withdrawn too early then the Euro area, in fact, faces the risk of getting trapped in deflationary stagnation.

Summing up this brief survey of short-run macroeconomic policy reactions towards the crisis we have to acknowledge that, although the macroeconomic anti-crisis policies have again been very expansionary in the US, there is still a serious risk of future deflation for the US economy. And it remains an open question when the expansionary fiscal policy stance will have to be terminated for political reasons and therefore aggregate demand will be dampened again. Whereas ECB interest rate policies have again failed to contribute to stabilising the economy, fiscal policies in Germany and the Euro area have been more expansionary than in past recessions but will most probably become restrictive again. Together with the pressure on wages this might cause a deflationary stagnation. If this occurs

Germany and the Euro area will certainly not contribute to replacing the US as a world engine of demand and growth in the future.

4. Requirements for a Global Keynesian New Deal

Given our analysis so far, even if the present anti-crisis policies are effective in stabilising the economy in the short run, we cannot expect the world economy to return to the dynamic pre-crisis growth path driven by debt-financed consumption in the US. Private deficit spending in the US will be restricted. This can already be seen in the development of the private sector financial balance which quickly switched from a substantial deficit of almost 4 per cent of GDP in 2006 to a surplus of 4 per cent of GDP in 2008 (Figure 6). And while the US government may run fiscal deficits of around 10 per cent of GDP for a few years, thereby compensating for the fall in private consumption spending, it will not do so forever. Therefore, the US will not be able to act as the engine for world demand, and it will have to be relieved by other countries, in particular the current account surplus countries.[14] What is required is therefore a Global Keynesian New Deal which addresses the three main causes of the present malaise, i.e. the inefficient regulation of financial markets, the inequalities in income distribution, and the imbalances in the current accounts at the global scale.[15] The Global Keynesian New Deal should be a policy package[16] containing first, re-regulation of the financial sector in order to prevent future financial excesses and financial crises; second, re-orientation of macroeconomic policies, in particular in the current account surplus countries; and third re-construction of international macroeconomic policy co-ordination – in particular on the European level – and a new world financial order. In what follows we will sketch the main building blocks of such a Global Keynesian New Deal.

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

Re-regulation of the financial system requires a host of measures which should aim at orienting the financial sector towards financing real economic activity, namely real investment and real GDP growth.[17] It has at least three dimensions:

[14] See also Godley et al. (2008) and Papadimitriou (2009) for similar conclusions with respect to the US.
[15] For similar views see Fitoussi/Stiglitz (2009), Guttmann (2009) and Wade (2009), although with different emphasis on the various components.
[16] Kregel (2009b), for example, shows that just bailing out the financial sector won't work in terms of stimulating the economy.
[17] For a more detailed list of required regulation see, for example, Ash et al. (2009), Fitoussi/Stiglitz (2009), and Wade (2009).

First, re-regulation of the financial sector includes measures which increase transparency in financial markets in order to reduce the problems of asymmetric information, moral hazard, and fraud, which are inherent to this sector in particular, and which have contributed to the present crisis:

- standardisation and supervision of all financial products,
- no off-balance sheet operations,
- national and international regulation and supervision of all financial intermediaries (banks, insurances, hedge funds, private equity funds, etc.),
- independent public rating agencies instead of private ones,
- strong public and cooperative banks supplying credit to households and small firms and thus competing with private banks,
- public ownership of financial institutions with systemic importance, because stability of these institutions can be considered to be a public good.

Second, re-regulation should generate incentives for economic agents in the financial and non-financial sectors encouraging them to focus on long-run growth rather than short-run profits:

- reduction of securitisation in order to prevent 'originate and distribute' strategies, and to make banks do what banks are supposed to do, i.e. evaluate potential creditors and their investment projects, grant credit and supervise the use of credit, and take care of the fulfilment of payment commitments by the creditor,
- reduction or abolition of share buy backs in order to prevent managers from manipulating share prices,
- reduction of stock option programmes for managers and extended minimum holding periods in order to reduce short-termism,
- extended co-determination on the firm level and improved rights of other stakeholders in the firm.

Third, even if measures related to issue one and two above are introduced, instability in the financial sector might arise. Measures directed at containing this instability should be implemented:

- equity regulation for all financial intermediaries, which should have counter-cyclical properties – different from Basel II regulation –,[18] and which reduce leverage on average, and thus require a higher capital base,[19]

[18] On the problems of Basel II regulations see for example Springler (2007).
[19] On counter-cyclical capital requirements see Goodhart (2009).

- asset-based reserve requirements for all financial intermediaries, which also have counter-cyclical properties and can be applied in order to prevent over-heating and bubbles in particular markets, but also to direct credit and investment towards socially preferable areas,[20]
- a general transaction tax for all financial transactions[21] and a general capital gains tax – also for corporations – in order to reduce speculation and volatility of short-term financial market flows.

4.2 Re-orientation of macroeconomic policies

Macroeconomic policies, in particular in current account surplus countries, have to be re-orientated towards improving domestic demand, employment, and hence also imports. Therefore, neo-mercantilist strategies will have to be abandoned, in particular in Germany, Japan and China. In Hein/Stockhammer (2009, 2010) a blueprint for a Post-Keynesian macroeconomic policy mix – as opposed to the New Consensus model focussing on labour market deregulation in order to reduce the NAIRU, and on monetary policy for short-run real and long-run nominal stabilisation – has been developed which can be used as a foundation for our suggestions here. Macroeconomic policies should be co-ordinated along the following lines:

First, central bank's 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. Varying interest rates have cost effects on the business sector, which may be effective in achieving inflation targets in the short run, in particular if the economy suffers from accelerating inflation but not necessarily if accelerating disinflation or deflation prevail, due to the zero lower bound of the nominal interest rate. In the long run, however, rising interest rates, applied successfully in order to stop accelerating inflation in the short run, will feed cost-push inflation again. Therefore, central banks should focus on setting low real interest rates in order to avoid unfavourable cost and distribution effects on firms and workers, while favouring rentiers.[22] A slightly positive real rate of interest, below the long-run rate of productivity growth, seems to be a reasonable target: Rentiers' real financial wealth will be protected against inflation, but redistribution in favour of the productive sector

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[20] On the properties of asset based reserve requirements see, in particular, Palley (2003, 2004, 2010) and Holz (2007).
[21] See Schulmeister/Schratzenstaller/Picek (2008) for a recent proposal.
[22] See Rochon/Setterfield (2007) for a review of Post-Keynesian suggestions regarding the 'parking it' approach towards central banks' interest rate policies and the rate of interest central banks should target.

and at the expense of the unproductive rentiers' sector will take place, which should be favourable for real investment, employment and growth. Further on, central banks have to act as a 'lender of last resort' in periods of liquidity crisis, and central banks should be involved in the regulation and the supervision of financial markets, as suggested in the previous sub-section. This includes the definition of credit standards for refinance operations with commercial banks, and the implementation of compulsory reserve requirements for different types of assets to be held with the central bank, in order to channel credit into desirable areas and to avoid credit-financed bubbles in certain markets.

Second, incomes and wage policies should take responsibility for nominal stabilisation, i.e. stable inflation rates at a level consistent with a balanced current account. In the end, accelerating inflation is always the result of unresolved distribution conflicts. With the degree of monopoly in the goods market and hence profit aspirations of firms given, nominal wages should rise according to the sum of long-run growth of labour productivity plus the target rate of inflation set by the government. In order to achieve the nominal wage growth target, a high degree of wage bargaining co-ordination at the macroeconomic level, and organised labour markets with strong labour unions and employer associations seem to be a necessary condition.[23] Minimum wage legislation, in particular in countries with highly deregulated labour markets and increasing dispersion of wages, will also be helpful for nominal stabilisation at the macroeconomic level, apart from its usefulness in terms of containing wage inequality. Further deregulation of the labour market, weakening labour unions, and reductions in the reservation wage rate by means of cutting unemployment benefits, however, will be detrimental to nominal stabilisation and will rather impose deflationary pressure on the economy.

Third, fiscal policies should take responsibility for real stabilisation, full employment and also a more equal distribution of disposable income. This has several aspects. By definition the excess of private saving (S) over private investment (I) at a given level of economic activity and employment has to be absorbed by the excess of exports (X) over imports (M) plus the excess of government spending (G) over tax revenues (T): S-I = X-M + G-T. Therefore, with balanced trade – or balanced current accounts – government deficits have to permanently take up the excess of private saving over private investment in order to assure a high desired level of employment.[24] As is well known from Domar (1944), a permanent government deficit with a constant long-run GDP growth rate will make the

[23] See Hein (2002) for a review of the related theoretical and empirical literature.
[24] This is, of course, the 'functional finance' view, pioneered by Lerner (1943). See also Arestis/Sawyer (2004).

government debt-GDP ratio converge towards a definite value. Therefore, there will be no problem of accelerating public debt-GDP ratios. Further more, low real interest rates – falling short of GDP growth and hence of tax revenue growth – will prevent redistribution in favour of rentiers. Permanent government deficits should be directed towards public investment in a wider sense (including increasing public employment), providing the economy with public infrastructure, and public education at all levels (Kindergarten, schools, high schools, universities) in order to promote structural change towards an environmentally sustainable long-run growth path. Apart from this permanent role of government debt, which also supplies a safe haven for private saving and thus stabilises financial markets, counter-cyclical fiscal policies – together with automatic stabilisers – should stabilise the economy in the face of aggregate demand shocks. Further on, progressive income taxes, relevant wealth, property and inheritance taxes, as well as social transfers, should aim at redistribution of income and wealth in favour of low income and low wealth households in order to reduce excess saving and to stabilise aggregate demand – without generating problems of unsustainable indebtedness for these households – and to improve automatic stabilisers.

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

In order to successfully implement the macroeconomic principles outlined in the previous section and to prevent global imbalances – which have been at the root of the present crisis – major changes are required in international macroeconomic policy coordination and in the world financial order.

On the European level, re-orientation of macroeconomic policies and macroeconomic policy coordination along the lines sketched above requires major institutional reforms. The institutional setting of the ECB and its monetary policy strategy have to be modified such that the ECB is forced to take into account the distributional, employment and growth effects of its policies, and to pursue a monetary policy of low real interest rates. In a first step, an adjustment towards the Federal Reserve's objectives might be helpful, which includes stable prices, maximum employment and moderate long-term interest rates on an equal footing (Meyer 2001). The Stability and Growth Pact at the European level has to be abandoned, and 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. In Hein/Truger (2007b) we have suggested the coordination of long-run expenditure paths for non-cyclical government spending, i.e. those components of spending which are under control of the

government. Such expenditure paths could be geared towards stabilising aggregate demand in the Euro area at full employment levels, and automatic stabilisers plus discretionary counter-cyclical fiscal policies could be applied to fight demand shocks. The orientation of labour market and social policies towards deregulation and flexibilisation will have to be abandoned in favour of re-organising labour markets, stabilising labour unions and employer associations, and Euro area-wide minimum wage legislation. Finally, attempts at effective macroeconomic policy coordination among monetary, fiscal and wage policies – for which the Macroeconomic Dialogue (Cologne-Process) supplies an institutional basis – will have to be made.[25]

On the international level, the return to a world financial order with fixed but adjustable exchange rates, symmetric adjustment obligations for current account deficit and surplus countries, and regulated international capital markets is required in order to avoid the imbalances that have caused the present crisis. Keynes's (1942) proposal for an International Clearing Union can be seen as a blueprint for this: As is well known, Keynes suggested an International Clearing Union in a fixed but adjustable exchange rate system, with the 'bancor' as international money for clearing operations between central banks, the Clearing Union as an international central bank financing temporary current account deficits, and selective controls of speculative capital movements between currency areas. What is most important for the present situation is that, according to Keynes (1942), whereas permanent current account deficit countries would be penalised in order to contract domestic demand (or to depreciate their currencies), also permanent current account surplus countries should be induced to expand domestic demand and thus to increase imports (or to appreciate their currencies), so that the whole burden of adjustment does not have to be carried by the deficit countries. This should give an overall impetus to world aggregate demand which will be needed in the future, not only in the short run but also in the long run.[26]

UNCTAD (2009: 51-53) has recently proposed a system of managed exchange rates which aims at stable real exchange rates by way of nominal wage policies following long-run productivity growth, and an inflation target consistent with stable real exchange rates in each country. Nominal exchange rates would have to adjust if nominal wages and inflation failed to generate stable real exchange rates. In order to prevent speculation under the conditions of

[25] See Hein/Niechoj (2007), Hein/Truger (2005a) and the papers in Hein et al. (2005) for the deficiencies of macroeconomic policies and macroeconomic policy coordination in the Euro area and for an outline of required institutional reforms.

[26] See Guttmann (2009) and Kregel (2009a) for a more detailed discussion of the needs for a reform of the international monetary system.

rather free movement of capital, nominal interest rates should be set such that the interest parity conditions should be maintained, and speculative attacks should be countered symmetrically, by both the country with depreciation pressure and the country with an appreciating currency. A redesigned system should be a multi-polar one, with several lead currencies linked to each other through symmetric, managed floating systems with exchange automatically adjusted by relative price differentials, and satellites linked to the lead currencies. Although the UNCTAD system seems to be a step into the right direction, it contains at least one major shortcoming: National interest rate policies have to be applied in order for the interest parity conditions to hold, and thus to counter currency speculation. However, this might contradict our suggestion of a policy of low interest rates geared towards domestic distribution targets. Therefore, the UNCTAD scheme would have to be further developed in order to solve this dilemma of monetary policies in a world of free capital mobility. As is well known, this dilemma can only be solved if restrictions on capital mobility are imposed.[27] A related scheme will have to be developed.

5. Conclusions

We have analysed the long-run imbalances of finance-dominated capitalism underlying the present crisis, with a focus on developments in the US and Germany as representative countries. We have argued that beyond inefficient regulation of financial markets, increasing inequalities in income distribution and rising current account imbalances at the global scale – associated with finance-dominated capitalism since the early 1980s – should be considered the main underlying causes for the severe global financial and economic crisis. Although the breakdown of the world economy could be halted by monetary policy interventions providing liquidity on a massive scale to the money market – thus preventing a meltdown of the financial sector – and in particular, by massive fiscal expenditure programmes, we have argued that due to the underlying imbalances the world economy is unlikely to return to its pre-crisis growth path. In particular, the US will not be able to act as the driver for world demand, in the short- or in the long term. This will have major implications for economic policies far beyond immediate responses to the crisis, in particular for those countries which in the past have benefitted from soaring US demand, the countries with huge current account surpluses. Against this background, we have formulated the following long-run requirements for economic policies to prevent sustained deflationary depression in major parts of the world.

[27] See Keynes's (1942: 187-189) proposal for an International Clearing Union, in which he also allows for selective capital controls. See also Davidson (2009: 134-142) and Wade (2009).

The policy package of a Global Keynesian New Deal should address the three main causes for the crisis, inefficient regulation, increasing inequality in income distribution and imbalances at the global scale, and should consist of the following elements: 1. Re-regulation of the financial (and the real) sectors in order to increase transparency and reduce asymmetric information; to generate incentives for long-run growth; and to contain systemic instability; 2. Re-orientation of macroeconomic policies along (post-)Keynesian lines with monetary policies by central banks being responsible for low real interest rates and for stability of the financial sector; wage and income policies taking care of nominal stabilisation and stable income shares; and fiscal policies being in control of real stabilisation in the short- and long–run, and of redistribution of income and wealth; 3. Re-construction of international macroeconomic policy co-ordination – in particular on the European level; and a new world financial order, in order to allow for the implementation of the macroeconomic policy package outlined above and to tackle global imbalances. It remains to be seen whether such a policy package will be politically feasible.

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