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POLICYBRIEF

FINANCIALISATION ECONOMY SOCIETY AND SUSTAINABLE DEVELOPMENT

Regime changes in the course of the crisis: tendencies towards mercantilism and economic policy challenges

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We review the macroeconomic regimes before and after the financial and economic crises and detect a reinforced tendency towards export-led mercantilist strategies, which means a major challenge for economic policies, in the short but also in the long run.

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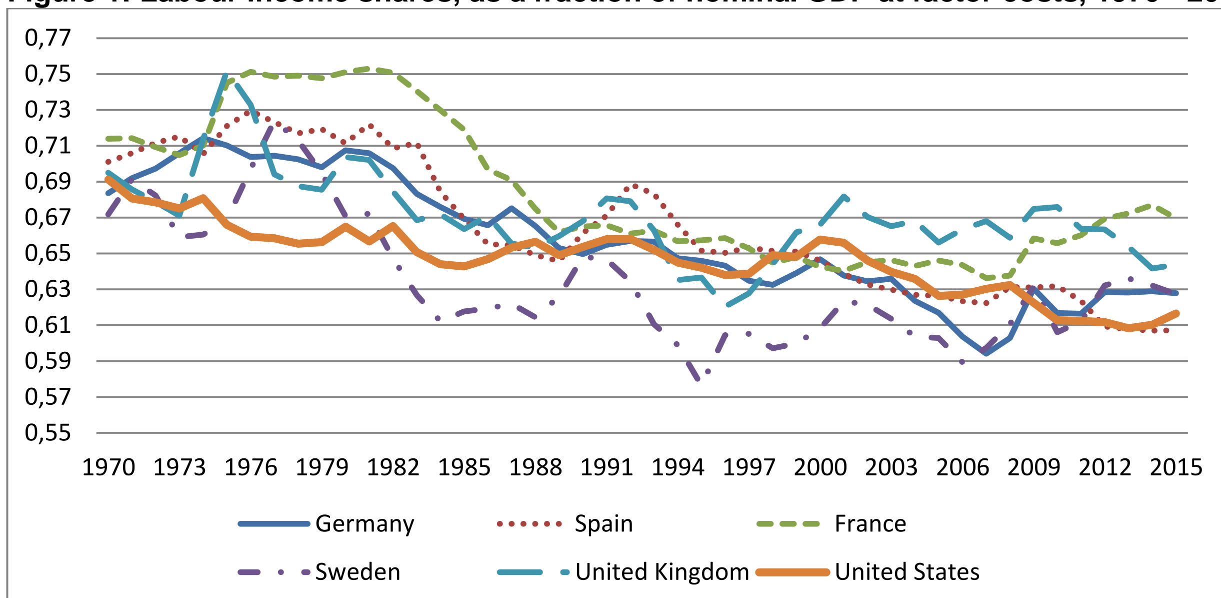
INTRODUCTION

The increasing dominance of finance starting in the late 1970s/early 1980s in the US and the UK, and somewhat later in other countries, was associated with two fundamental and structural processes generating the contradictions of this phase of development and finally the financial and economic crises starting in 2007: first, the deregulation of the financial (and economic) system and, second, the rising concentration of wealth, as well as the massive redistribution of income at the expense of labour (Figure 1) and low income households, in particular. These fundamental processes provided the conditions for the generation of major imbalances

within some of the economies, on the one hand, and at the international level, on the other hand.

The redistribution of income at the expense of the labour income share, and of low labour incomes in particular, and thus downward pressure on income-financed consumption demand together with depressed investment in the capital stock, each a major feature of financialisation, caused potential problems for effective demand and growth. However, the deregulation of the financial system provided a way out of this, and two short- to medium-run dynamic 'profits without investment' regimes emerged. These regimes were either driven by flourishing debt-financed consumption demand or by rising export surpluses, compensating for low income-financed consumption and weak or falling investment in the capital stock. However, each type of these regimes, the debt-led private demand boom type and the export-led mercantilist type, suffered from a major contradiction and instability potential: The rising household debt-income ratios in the countries of the debt-led private demand boom regime, which were also current account deficit countries and thus the counterparts of the export-led mercantilist countries running current account surpluses, were not sustainable and generated high financial fragility.

Figure 1: Labour income shares, as a fraction of nominal GDP at factor costs, 1970 - 2015



Source: AMECO Database of the European Commission

As is well known, the mal-regulation of the financial sector, the re-distribution of income and the emanating macroeconomic imbalances led eventually to the deep crises, the global financial crisis starting in 2007, the Great Recession of

2008/9, and finally the euro crisis starting in 2010. In the course of these crises up to the present, the international regime constellation has changed, with a tendency of countries either moving towards or staying with the export-led mercantilist regime or shifting towards a domestic demand-led regime sustained by government deficits. Simultaneously, however, after an initial period of expansive fiscal policies, which aimed to stabilise the financial and the 'real' economy during the financial and economic crises, government deficits and debt have been considered a major problem and austerity policies, debt ceilings and debt brakes have been introduced, in particular since the onset of the euro crisis. This policy response is a major problem for the global constellation. Therefore, in the short run, in order not to run into the next global recession, a change in the academic and public attitude towards the role of public deficits is required. Moreover, a greater fundamental change in economic policies is at stake for the long run, dealing with the structural problems which have generated the highly fragile constellation still underlying the current situation: the deregulated financial (and economic) system and the highly unequal distribution of income and wealth.

Evidence and Analysis

The demand and growth regimes can be distinguished by considering financial balances of the main macroeconomic sectors (private household sector, financial and non-financial corporate sectors, government sector, external sector), as well as the growth contributions of the main demand aggregates (private consumption, public consumption, private investment, public investment, net exports). On the one hand, this provides some information about the main drivers of growth, and, on the other hand, on how demand is financed. The sectoral financial balances of a country should sum up to zero, apart from statistical discrepancies, because a positive financial balance of one sector needs a respective negative financial balance of another sector – a creditor needs a debtor and vice versa. And the growth contributions of the demand aggregates should sum up to real GDP growth of the respective country.

The debt-led private demand boom regime is characterised by negative financial balances of the private household sector, in some countries accelerated by corporate deficits and thus deficits of the private domestic sectors as a whole, positive financial balances of the external sector, and hence, current account deficits, high growth contributions of private domestic demand, and of private consumption demand in particular, as well as negative growth contributions of the balance of goods and services. In the trade cycle before the crises we find this regime in the US, the UK and Spain, among other countries (Table 1 and 2). These countries were the world demand engines before the crisis, mainly relying on increasing household debt.
The export-led mercantilist regime is characterised by positive financial balances of the domestic sectors as a whole, and hence negative financial balances of the external sector, and thus, current account surpluses. The growth contributions of domestic demand are rather small or even negative in certain years, and growth is mainly driven by positive contributions of the balance of goods and services and hence rising net exports. In the trade cycle before the crises we find this regime in Germany and Sweden, among other countries (Table 1 and 2). These countries were free-riding on dynamic world demand generated by the debt-led private demand boom countries, in particular.

Finally, we have in between the two extremes the domestic demand-led regime. It is characterised by positive financial balances of the private household sector, as well as of the external sector, and hence, current account deficits. Here it is usually the government and, to a certain degree, the corporate sector, that are running deficits. We have positive growth contributions of domestic demand without a clear dominance of private consumption, and negative growth contributions of the balance of goods and services. In the trade cycle before the crises, we find this regime in France, among other countries (Table 1 and 2).

The countries following the two extreme regimes before the crisis, the debt-led private demand boom regime and the export-led mercantilist regime, generated rising current account imbalances in the global economy, but also within the Eurozone (Figure 2). Apart from the countries mentioned so far, in particular China and Japan, as export-led mercantilist economies, contributed to this global

constellation, which then contributed to the severity of the financial crisis and the Great Recession. The crisis started in the main debt-led private demand boom country, the US, and was transmitted to the world economy through the international trade channel and the financial contagion channel. Initially, the export-led mercantilist countries were hit hardest, however, these economies managed to recover quickly with the recovery of the world economy, driven by the ongoing dynamic development in countries like China, India and other emerging market economies.

Table 1: Sectoral financial balances as a share of nominal GDP, in per cent, average values for the trade cycle, early 2000s to 2008

	US	*UK*	*Spain*	*Germany*	*Sweden*	*France*
	2001-2008	*2002-2008*	*2002-2008*	*2003-2008*	*2001-2008*	*2003-2008*
External sector	4.7	2.2	6.3	-4.9	-6.9	0.4
Public sector	-4.4	-3.4	0.0	-2.0	1.0	-3.1
Corporate sector	0.4	1.5	-4.2	1.2	3.2	-0.2
Private household sector	-0.5	-0.3	-2.1	5.7	2.4	2.9

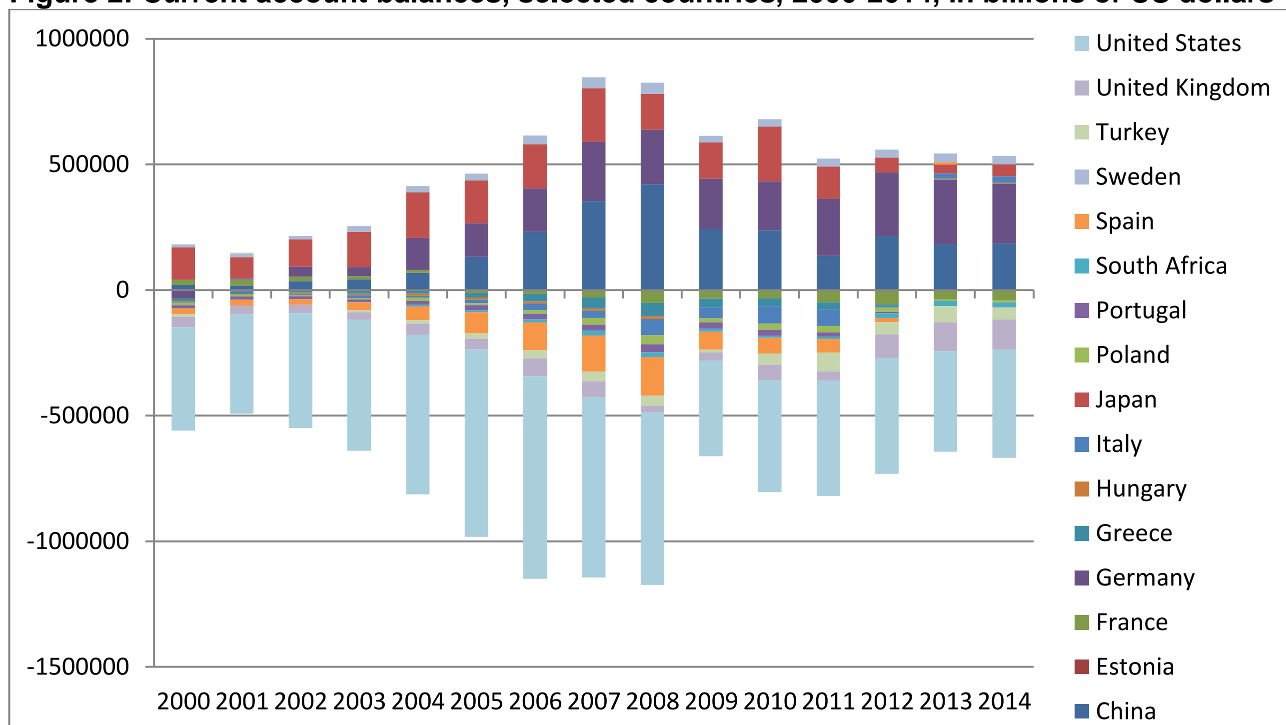
Note: The beginning of a trade cycle is given by a local minimum of real GDP growth.
Source: AMECO Database of the European Commission, calculations by Dodig/Hein/Detzer (2016)

Table 2: Real GDP growth, in per cent, and growth contributions, in percentage points, average values for the trade cycle, early 2000s to 2008

	US	*UK*	*Spain*	*Germany*	*Sweden*	*France*
	2001-2008	*2002-2008*	*2002-2008*	*2002-2008*	*2001-2008*	*2003-2008*
Real GDP growth	2.1	2.5	3.1	1.5	2.6	1.7
Contribution to the increase of GDP of:						
Private consumption	1.7	1.7	1.6	0.3	1.0	1.0
Public consumption	0.3	0.5	0.9	0.2	0.2	0.4
Investment	0.2	0.4	1.1	0.4	0.9	0.7
Balance of goods and services	-0.1	-0.1	-0.7	0.6	0.5	-0.4

Note: The beginning of a trade cycle is given by a local minimum of real GDP growth.
Source: AMECO Database of the European Commission, calculations by Dodig/Hein/Detzer (2016)

Figure 2: Current account balances, selected countries, 2000-2014, in billions of US dollars



Source: IMF

With the deep financial and economic crises some major changes in the demand and growth regimes took place, looking at the averages in the period 2009-14 (Tables 3 and 4). In the debt-led private demand boom countries, like the US, the UK and Spain, the private sector, i.e. the private households and partly the corporations, had to deleverage. The financial balances of these sectors thus became positive and the growth contributions of private consumption and investment shrank considerably – in Spain they even became negative on average over the considered period. High public deficits stabilised the economy and allowed for low but positive growth in the US and the UK, with the balances of goods and services slightly contributing. However, the current accounts remained considerably negative and thus the financial balance of the external sectors stayed positive. The US and the UK hence moved from a debt-led private demand boom regime towards a domestic demand-led regime mainly stabilised by public sector deficits. The willingness to continue to accept high current account deficits has so far contributed to the stabilisation of global demand in the world economy. Spain has been a different case. Initially in the crisis, high public sector deficits allowed the private sector to generate financial surpluses. However, with the euro crisis since 2010 and the austerity policies implemented, public deficits have been reduced, public and private domestic demand have collapsed and real GDP growth has turned negative. Positive growth contributions only came from the balance of goods and services, mainly

because of falling imports, the current account improved, and, on an annual basis, has become positive since 2013 (Figure 2). Spain has thus moved from a debt-led private demand economy towards an export-led mercantilist economy. The same has been true for other Eurozone crisis countries, like Greece and Portugal.

In the export-led mercantilist countries, Germany and Sweden, the public sector accepted high financial deficits in the crisis in order to stabilise the private sector and the macro-economy. However, these deficits could be passively consolidated, because of the rapid economic recovery, initially driven by net exports. The financial balances of the private sector remained positive, both for private households and the corporations. On average over the period 2009-14 economic growth was driven by domestic demand; the balance of goods and services did not contribute any more, in Sweden the growth contributions even turned slightly negative. However, these countries still show considerable current account surpluses, and thus negative financial balances of the respective external sectors. In Germany these surpluses even exceed those before the crisis, whereas in Sweden they are only slightly lower. These countries have thus continued to broadly follow the export-led mercantilist regime.

The domestic demand-led regime in France has not changed much in the crisis and the following years. Financial surpluses of private households were mopped up to a lesser degree by corporations but more so by the public sector. Due to the stabilisation requirements, public sector deficits have increased relative to the cycle before the crises. The same is true for the current account deficit, and thus the financial surpluses of the external sector. Public deficits in France are thus stabilising global demand for goods and services, too. The meagre growth in France was driven by domestic demand, and mainly by public consumption.

Table 3: Sectoral financial balances as a share of nominal GDP, in per cent, average values for 2009 - 2014

	US	*UK*	*Spain*	*Germany*	*Sweden*	*France*
	2009-2014	*2009-2014*	*2009-2014*	*2009-2014*	*2009-2014*	*2009-2014*
External sector	2.7	3.1	1.2	-6.6	-6.1	2.0
Public sector	-9.1	-7.9	-8.7	-1.2	-0.9	-5.4
Corporate sector	3.3	2.8	4.2	2.6	0.7	-0.7
Private household sector	4.0	1.9	3.3	5.2	6.2	4.1

Source: AMECO Database of the Europena Commission, calculations by Dodig/Hein/Detzer (2016)

Table 4: Real GDP growth, in per cent, and growth contributions, in percentage points, average values 2009-2014

	US	*UK*	*Spain*	*Germany*	*Sweden*	*France*
	2009-2014	*2009-2014*	*2009-2014*	*2009-2014*	*2009-2014*	*2009-2014*
Real GDP growth	1.3	0.8	-1.0	0.6	1.1	0.3
Contribution to the increase of GDP of:						
Private consumption	1.0	0.3	-0.8	0.5	0.9	0.2
Public consumption	0.0	0.2	0.0	0.2	0.4	0.4
Investment	0.1	0.1	-1.7	0.1	0.0	-0.3
Balance of goods and services	0.1	0.1	1.5	0.0	-0.2	0.0

Source: AMECO Database of the Europena Commission, calculations by Dodig/Hein/Detzer (2016)

Overall, we find that global current account imbalances have been slightly reduced, if compared to the years before the crises. However, they are still much more pronounced than in the early 2000s (Figure 2). The high current account surpluses by the export-led mercantilist countries, in particular Germany and China, but also Japan, Sweden, and now Spain, are matched by current account deficits of domestic demand-led economies with high public sector deficits, in particular the US, the UK and France. The risks of such a global constellation are obvious. If ever more countries, like currently the whole Eurozone driven by austerity and deflationary stagnation policies, move towards an export-led mercantilist strategy, the world economy is facing an aggregation problem. It will become increasingly

difficult to generate the related current account deficits in other regions of the world. Dominating tendencies towards stagnation are the inescapable consequences, as have been prominently discussed recently again. And to the degree that global demand stabilisation has to rely on public sector financial deficits in the domestic demand-led economies, there are the risks and dangers of politically induced debt ceilings and debt brakes for the public sector.

Policy Implications and Recommendations

From the findings outlined in the previous section and the diagnosis of the current regime constellation, with the related stagnation and instability risks, it follows for the short run that the role of public deficits and debt for stabilisation purposes has to be reconsidered. The aim of balanced or in surplus public budgets, dominating EU policies in particular, has to be given up. It also means that modern macroeconomics would have to accept the active role of fiscal policies and public deficits if required for macroeconomic stabilisation purposes.

In the long run, however, the underlying structure of the current constellation still dominated by the structural features of financialisation would have to be challenged and changed. This should have four dimensions:

Re-regulation and downsizing of the financial sector,

Re-distribution of income (and wealth) from top to bottom and from capital to labour,

Re-orientation of macroeconomic policies towards stabilising domestic demand at non-inflationary full employment levels,

Re-creation of international monetary and economic policy coordination.

The 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. This has at least three dimensions. First, measures which increase transparency in financial markets should be introduced in order to reduce the problems of uncertainty, asymmetric information, moral hazard, and fraud, which are inherent to and were widely observed in this sector, in particular. These measures include the standardisation and

supervision of all financial products in order to increase transparency in the market. Off-balance sheet operations should be abolished and national and international regulation and supervision of all financial intermediaries (banks, insurances, hedge funds, private equity funds, etc.) should be introduced. Since rating can be considered a public good, independent public rating agencies will have to be introduced replacing the private ones. Diversity in the banking sector should be increased in order to reinforce resilience. Therefore, public and cooperative banks supplying credit to households and small firms should be strengthened. In addition, the role of local banks, with special knowledge and a particular interest in their regions (solving some of the information asymmetry and moral hazard issues), should be stressed instead of trying to create international financial champions. Financial institutions with systemic relevance should be in public ownership, because stability of these institutions can be considered to be a public good, too. Second, re-regulation should generate incentives for economic actors in the financial and non-financial sectors to focus on long-run growth rather than short-run profits. This includes the reduction of securitisation in order to prevent 'originate and distribute' strategies which were at the root of the US subprime mortgage crisis. Banks should be induced to do what banks are supposed to do, i.e. evaluate potential borrowers and their investment projects, grant credit and supervise the fulfilment of payment commitments by the debtors. For the financial and non-financial corporate sector, share buy backs in order to drive share prices up should be reduced or even abolished. Short-termism of managers in the corporate sector should be minimized by means of reducing stock option programmes and by extending minimum holding periods. Generally, co-determination on the firm level and improved rights of other stakeholders in the firm should be strengthened in order to overcome short-termism and to increase the importance of investment in long-term projects improving productivity and developing new products. Third, measures directed at containing systemic instability, like credit controls, asset-based reserved-requirements and counter-cyclical capital requirements for all financial intermediaries should be introduced, and a general financial transactions tax in order to slow down activity in the financial sector should be implemented.

Apart from stabilising and orienting the financial

sector towards financing real economic activity, re-regulating finance should contribute to the re-distribution of income and wealth from top to bottom and from capital to labour, and thus also positively feedback on aggregate demand and growth through the following channels: First, since these measures imply a downsized financial sector they will contribute to an increasing labour income share through the change in the sectoral composition of the economy, to the extent that the financial sectors have a lower wage share than the non-financial sectors of the economy. Second, reducing top management salaries and profit claims of financial wealth holders will allow for lower mark-ups in price setting of firms and thus higher labour income shares. Third, refocusing management's orientation towards long-run expansion of the firm will increase bargaining power of workers and trade unions and therefore have a dampening effect on profit claims. Furthermore, institutions for coordinated collective bargaining would have to be re-created to provide the conditions for wage bargaining to be focussed on macroeconomic outcomes and to implement stabilising nominal wage growth. Nominal wages should grow at a rate given by the sum of long-run national labour productivity growth plus the inflation target. Institutional pre-conditions seem to be strong trade unions and employer associations, as well as government interventions, if required, through wage bargaining in the public sector, legal extensions of bargaining results in the private sectors and through legal minimum wages, for example. Apart from stabilising primary functional distribution of income, the inequality of personal disposable income distribution would have to be tackled through progressive income and wealth taxes and through social transfers.

The re-orientation of macroeconomic policies – in particular in current account surplus countries – should aim at improving domestic demand, employment and hence also imports into these countries. First, interest rate policies of the central bank should abstain from attempting to fine tune unemployment in the short run and inflation in the long run. Central banks should instead target low real interest rates in order to promote real economic activity. A slightly positive real rate of interest, below the rate of productivity growth, seems to be a reasonable target. Rentiers' real financial wealth will be protected against inflation, but overhead costs for firms will be reduced, allowing for a shift of income distribution in favour of labour with stimulating effects

on aggregate demand. Further on, central banks must act as a lender of last resort in periods of liquidity crisis, not only for the banking system but also for the government. The latter provides the conditions for fiscal policies to fulfil its stabilising role.

Fiscal policies should take over full responsibility for real stabilisation, full employment and a more equal distribution of disposable income. Progressive income tax policies, relevant wealth, property and inheritance taxes, and re-distributive social policies would improve the conditions for an income-led recovery. If required by surpluses in private sector financial balances, medium- to long-run government deficits should maintain aggregate demand at high levels thus allowing for high non-inflationary employment. In particular in current account surplus countries with private sector financial surpluses, governments will have to run budget deficits in order to stabilise aggregate demand at the national level, on the one hand, and in order to contribute to rebalancing the current accounts at the international level, on the other hand. Fiscal policies will therefore have a major role to play in rebalancing current accounts at the global and the regional (Eurozone) levels. Unfavourable regressive distribution effects of public debt can be avoided by central bank policies targeting low interest rates, as recommended above, and/or by appropriate taxation of capital income. Short-run aggregate demand shocks should be countered by automatic stabilisers and by discretionary counter-cyclical fiscal policies.

Incomes and wage policies should take over responsibility for nominal stabilisation, i.e. stabilising inflation at some target rate which contributes to maintaining a balanced current account, to the extent that exports and imports are sufficiently price-elastic. In order to contribute to rebalancing the current accounts, nominal wage growth in the current account surplus countries will have to exceed the benchmark of national long-run productivity growth plus the inflation target for an interim period, whereas nominal wage growth in the deficit countries will have to fall short of this benchmark during the adjustment process, however, without driving the economy towards deflation.

The re-creation of international monetary and economic policy coordination would have to make sure that export-led mercantilist strategies no longer pay off. This implies that targets for current account balances have to be included into international policy

coordination at the regional and the global level. At the global level the return to a cooperative world financial order and a system with fixed but adjustable exchange rates, symmetric adjustment obligations for current account deficit and surplus countries, and regulated international capital flows seem to be required in order to avoid the imbalances that have contributed to the crisis and to preclude export-led mercantilist policies by major economies. Keynes's (1942) proposal for an International Clearing Union is an obvious blueprint to be further developed for this purpose.

Research Parameters

Work Package 3 of the FESSUD (Financialisation, Economy, Society, Sustainable Development) project has been concerned with 'Causes and Consequences of the Financial Crisis'. In the work package, theories of financial crisis, key works on previous financial crises, approaches towards changes in the relationship between the financial sector and the non-financial sectors of the economy ('financialisation') focussing on the effects on distribution, growth and crisis, have been examined in particular. Furthermore, the factors that generated and transmitted the recent financial crisis and which were discussed in the relevant literature were reviewed. This has provided the theoretical backgrounds for the second part of this work package, in which the long-run development of the relationships between the financial and the non-financial sectors of the economy and the effects of these developments on the current financial and economic crises have been analysed. This Policy Brief by the Work Package leader, Eckhard Hein (Berlin School of Economics and Law), draws on some of the results and provides some lessons for future structural, financial, distributional and macroeconomic policies aiming at a more resilient financial and economic system.

PROJECT IDENTITY

PROJECT NAME	Financialisation Economy Society and Sustainable Development (FESSUD)
COORDINATOR	Professor Malcolm Sawyer. University of Leeds, UK: email fessud@leeds.ac.uk
CONSORTIUM	University of Siena, Italy School of Oriental and African Studies, UK Fondation Nationale des Sciences Politiques, France Pour la Solidarité, Brussels, Belgium Poznan University of Economics, Poland Tallin University of Technology, Estonia Berlin School of Economics and Law, Germany Centre for Social Studies, University of Coimbra, Portugal University of Pannonia, Veszprem, Hungary National and Kapodistrian University of Athens, Greece Middle East Technical University, Ankara, Turkey Lund University,Sweden University of Witwatersrand, South Africa University of the Basque Country, Bilbao, Spain
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DURATION	1st December 2011 to 30th November 2016
BUDGET	EU contribution: 7,923,728.02 euros
WEBSITE	fessud.eu
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FURTHER READING

Dodig, N., Hein, E., Detzer, D. (2016): Financialisation and the financial and economic crises: Theoretical framework and empirical analysis for 15 countries, in: Hein, E., Detzer, D. and Dodig, N. (eds.) (2016).

Hein, E: (2015): Causes and consequences of the financial crisis and the implications for a more resilient financial and economic system: Synthesis of FESSUD Work Package 3, FESSUD Working Paper, No. 128, University of Leeds.

Hein, E., Detzer, D. and Dodig, N. (eds.) (2015): *The Demise of Finance-dominated Capitalism: Explaining the Financial and Economic Crises*, Cheltenham: Edward Elgar.

Hein, E., Detzer, D. and Dodig, N. (eds.) (2016), *Financialisation and the Financial and Economic Crises: Country Studies*, Cheltenham: Edward Elgar, 2016.