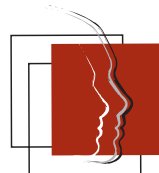


GURN

Global Union Research Network



International Labour Office
Bureau International du Travail
Oficina Internacional del Trabajo



From financial crisis to depression and deflation

Hansjörg Herr



The Global Union Research Network (GURN) is a cooperating project of the International Trade Union Confederation (ITUC), the Trade Union Advisory Committee to the OECD (TUAC), the ILO's International Institute for Labour Studies (IILS) and the Bureau for Workers' Activities (ACTRAV) of the ILO. The aim of the research network is to give union organizations better access to research carried out within trade unions and allied institutions.



Prof. Dr. Hansjörg Herr teaches Economics at the Berlin School of Economics. He works in the field of Financial Globalisation, Development Economics and European Integration.

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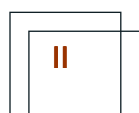
Hansjörg Herr

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INTRODUCTION

The subprime mortgage crisis that broke out in 2007 and escalated in 2008 is by no means an isolated case. Although unique, the crisis nevertheless follows a pattern which has been well studied in theory and investigated historically. In this article the question under scrutiny is whether and how the present financial crisis will affect economic growth and the level of prices for goods. In the first section the emphasis will be on state interventions after the escalation of the crisis in the fall of 2008. It is followed by a discussion of the danger of a “Great Depression” with a possible deflationary period. Finally, policies that could be implemented to prevent such a depression will be identified.

STABILISATION OF THE FINANCIAL SYSTEM WILL SUCCEED

All in all, central banks and governments have introduced the right policies to stabilise the world’s stumbling financial systems. The world’s central banks have taken over the role of lender of last resort and are in the process of providing an unlimited amount of liquidity. In addition to banks, other financial institutions, like investment banks, have been placed under the wings of central banks. A liquidity bottleneck is for this reason unlikely. Public households have offered guarantees and equity capital to financial institutions and are helping those institutions suffering from a lack of capital due to non-performing loans and sinking capital market prices. The intervention of public households is becoming expensive. Hopefully, the state will not simply hand out money. Instead, they need to demand ownership with all the rights and obligations of owners. This would appear to be the most fiscally economic way to handle the crisis. Also, in regulative terms, state ownership is indispensable as the financial system itself is the cause of the present situation and is unable to resolve the problems alone.

The financial crisis has given rise to the question of social justice. Before the outbreak of the crisis exorbitant incomes were being earned in the financial sector, but now the costs of the crisis are being borne by everyone. To attenuate social upheaval a higher tax on higher incomes and wealth appears indispensable. Willem Buiter proposes that the state takes over the power of decision for all institutions unable to survive without assistance. Governments could then fire managers, appropriate their incomes and bonuses, sell off some of the institutions, and ban businesses that work through tax havens and offshore locations. In the case of Germany, the Federal Financial Supervisory Authority (**Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)**) or the German Federal Bank (Bundesbank) (could represent the state in this function).¹

¹ Cp. W. Buiter, Notfalls verstaatlichen, in: Die Zeit, Nr. 42, 9 Oktober 2008.

THE DANGER OF A „GREAT DEPRESSION“

The era of the Great Depression during the 1930s provides us with a good example of the development of an asset market bubble and the inevitable consequences of an asset price deflation. Japan during the 1990s is another exemplary case, after the end of its capital market and real estate bubble that had started in the second half of the 1980s. What these two periods exemplify is that asset market deflations lead to liquidity and solvency problems as a result of the drastic tightening of credits to the private sector and a fall in asset prices and destruction of equity. One of the reasons why Joseph Stiglitz was awarded the Nobel Prize was because he made it clear that a rationing of credit always takes place in financial markets. This is due to the fact that because creditors do not have complete information about debtors, they do not grant loans to every applicant. As the example of Japan after the mid-1990s illustrates, even a zero interest rate policy can't force banks to expand credit. Due to sinking real estate and capital market prices which reduce the wealth of debtors, the situation is exacerbated by the fact that creditors have less to fall back on in the case of loan default. In the present situation, given the banks' negative forecast for the future, the shrunken equity capital of the financial system and the diminishing collateral of debtors, the danger of a sharp credit rationing towards the private sector appears to be compelling, and a sharp recession in many industrial countries unavoidable. Although short-term injections of capital by governments can alleviate the financial institutions' problem of equity capital, this will not necessarily avert their rationing of credit. And even if governments take over the management of banks, this will not immediately affect the hesitation of banks to grant loans.²

A reduction of the credit volume doesn't only come from the supply side. Debtors – whether corporate or private households – are becoming more wary about taking out loans, as they too are being forced to handle their affairs in an insecure financial environment. Due to falling capital market and real estate prices, both companies and households have had to cope with the burden of high asset losses. This drop in people's wealth has a negative effect on their willingness to borrow and suppresses consumption and investment demand.

In summary, one can say that theoretical arguments as well as historical experience with financial crises indicate that a massive shrinking of aggregate demand is to be expected, while a sharp recession and high job losses may also be likely. A dramatic reduction in demand tends to be accompanied by additional heavy losses in income and production. The spiral of income and job losses

² For the financial crisis cp. H. Herr, R. Stachuletz, „New Fashion in Finance“ und Finanzmarktstabilität, in: WSI Mitteilungen, 2007, Vol. 60, p. 650-656; H. Herr, R. Stachuletz, Deregulierung, Finanzmarktdesaster und Reformoptionen: Die Hoffnung stirbt zuletzt, in: Internationale Politik und Gesellschaft, Heft 3, 2008, p. 11- 27.

continues its downward spin; the market mechanism leads into a deeper and deeper crisis.

In this scenario there is another very real danger, namely the possibility of a goods market deflation. A falling price level is generated by two factors.³ First, because of a lack in the demand for goods, companies are forced to reduce production and then to lower their prices. During a cyclical downturn, demand deflation is unavoidable and appears regularly. However, the situation becomes even more dangerous when demand deflation is reinforced by a deflation of costs, which reflects the second factor of falling prices. Cost deflations originate in falling unit labour costs. For this reason nominal pay rises play a positive role, as they comply with a trend in the increase of productivity plus the target inflation rate of the central bank. If we assume an increase in productivity of 1.5 per cent for the mid-term in Germany and accept the low target inflation rate of the European Central Bank (ECB) of just under 2 per cent, the level of wages in Germany should increase annually by 3.5 per cent. If the increase in wages is lower than this norm or if they sink, deflation is the result. The recent development in Japan after the mid-1990s shows that deflationary periods are not ghosts from the 1930s. In Japan sinking wages reduced unit labour costs and brought on deflation. Although the deflationary process did not become cumulative, it was strong enough to force Japan into a stagnation that has not been completely overcome to this day. In Germany the increase in the macroeconomic wage level was also too low; the level of unit labour costs remained almost constant from the mid-1990s to 2007. In some years Germany was on the verge of deflation.⁴

Deflations in the goods market have devastating consequences for economic development because they increase the burden of debt for *all* debtors. In a deflation, the nominal revenues of debtors (turnover of firms, income of households) inevitably sink while nominal amortisation expenditures remain the same. As sure as death and taxes, a deflation at a high level of debt leads to massive financial breakdowns of companies and private households. Economic coherence falls apart because money flows break down in all corners of the economy. Irving Fisher was right in his analysis of the 1930s when he emphasised that in a deflation the economic boat not only rocks, it capsizes. It is obvious that a deflationary process drives down the demand for goods drastically. What company would purchase a machine today when they believe their competitors will be able to buy it for less in the future? What household will be willing to buy a

³ This argument is based on J. M. Keynes, *Treatise on Money* Cambridge: Cambridge University Press, 1930.

⁴ For the debate about deflation cp. T. I. Palley, *Keynesian Models of Deflation and Depression Revisited*, in: *Journal of Economic Behaviour and Organisation*, Vol. 68, 2008, p. 167-177; H. Herr, *The Labour Market in a Keynesian Economic Regime: Theoretical Debate and Empirical Findings*, in: *Cambridge Journal of Economics*, 2008, 1-17; M. Heine, H. Herr, *Volkswirtschaftslehre. Paradigmenorientierte Einführung in die Mikro- und Makroökonomie*, 3rd. edition, München: Oldenbourg 2003; M. Heine, H., Herr, *Die Europäische Zentralbank. Eine kritische Einführung in die Strategie und Politik der EZB und der Probleme der EWU*, 3rd. edition, Marburg: Metropolis 2008.

new car today when it will be cheaper in the future? Deflations are dangerous because they shatter the whole economic system of debtors and creditors, and bring about a cumulative shrinking of the demand for goods and production.

Deflationary processes appear when the nominal wage anchor cracks and nominal wages begin to sink. The nominal wage anchor against deflation is based on labour market institutions including wage bargaining systems that exclude wage reductions. The drama of the present economic situation is that *not only have the financial systems been deregulated worldwide since the 1980s, so to have labour markets*. This has meant that two of the most important columns of a stable economy have caved in. Germany serves as an example: an ever-greater number of employees work in volatile and precarious work situations; a coordinated wage bargaining mechanism only functions well in part of the economy; in some branches (especially in service industries), some regions (e.g. eastern Germany) and in certain types of businesses (i.e. small businesses) labour unions and employers' associations are so weak that the traditional system of wage bargaining no longer functions. If the current financial market crisis leads to a sharp recession and a medium-term stagnation in GDP growth, bringing about a wave of unemployment and a cracking of the wage anchor, developments such as those experienced in the 1930s are very likely. Not only Germany suffers from the danger of deflation. Japan will most likely fall back into deflation and there are also serious fears of a deflation in the United States. The wave of deregulation in the financial and labour markets has been accompanied by neo-liberal understanding and a neo-classical theoretical approach that took hold after the elections of Ronald Reagan and Margret Thatcher in the 1980s, and were copied by most western countries. These developments led the world economy into a constellation of instability, injustice and uncertainty.

THE STABILISATION OF DEMAND AND THE STRENGTHENING OF THE WAGE ANCHOR

The stabilisation of financial markets after the subprime debacle was imperative and the right thing to do, but to date it has been unable to prevent a sharp recession, while medium-term stagnation appears likely. There are two additional problem areas that need to be attended to: the stabilisation of the demand for goods and the strengthening of the wage anchor.

When private demand declines governments have the responsibility to stabilise macroeconomic demand. To begin with the state needs to let automatic stabilisers take effect. In part, this means accepting the reduction of tax revenues, for example, due to decreasing revenues from the value added and income taxes and the increase in public expenditures caused by increasing unemployment. However, this passive anti-cyclical governmental policy is insufficient on its own. Additional measures to support the economic downturn are imperative, whereby in principle, an increase in state expenditure is better than the lowering of taxes. Such a policy should be supported by government expenditures that would be financed by taxing high incomes and wealth, as well as drying up tax havens.

After its capital market and real estate bubble burst in the 1990s, Japan was only able to prevent a 1930s style development by means of state support of its ailing financial institutions and an expansionary fiscal policy over a period of many years. Nevertheless, despite this fiscal policy and a policy of zero interest rates, the public households in Japan and the Bank of Japan weren't able to enforce a recovery. Japan's national debt is about 200 per cent of GDP – the price of the asset market bubble and a deflationary development. But Japan made mistakes. From Japan we can learn that the insolvency problems of financial institutions require quick and decisive responses. Both monetary and fiscal policy must react promptly when confronted by asset market deflation, and, especially, a policy of wage reduction has very negative results.⁵

For labour markets, policies are needed that can prevent the cracking of the nominal wage anchor in a period of expectant rising unemployment. In Germany, for example, this is the reason why the introduction of a minimum wage is more important than ever before. Also, as was the custom previously, the government should be comprehensive in declaring labour agreements as binding for all companies in an industry and a region. The system of wage bargaining beyond the firm level should be strengthened; labour unions and employer's associations should receive sufficient political backing. Precarious jobs should be abolished systematically.

⁵ Cp. M. Heine, H. Herr, C. Kaiser, Wirtschaftspolitische Regime westlicher Industrieländer – theoretische Analyse und Fallstudien über Japan, Großbritannien, die USA und Deutschland, Baden-Baden: Nomos 2006..

In the Euro area, monetary policy is carried out by the European Central Bank (ECB). The areas of fiscal policy and the prevention of a cracking of the wage anchor should also be handled at the level of the European Monetary Union (EMU). European fiscal policy can only be effective when coordinated at the EMU level. In addition to the national economic programmes, investments for European infrastructure for example in the field of transport and ecology would be potential areas to spend money. In the medium term the European centre should have their own tax revenues and should be able to carry out their own fiscal policy. The EMU countries should band together to agree to a minimum wage and other labour market principles. Thoughts about a European economic “government” at the EMU level are headed in the right direction. In the end the EMU only makes sense when banking supervision, fiscal policy including taxation policies, minimum wages, wage bargaining systems, co-determination in businesses, industrial policy, etc. are coordinated at the EMU level. This allows for different paces within Europe. Countries that belong to EMU need to be the ones that drive efforts towards integration; other European Union countries, those that do not choose to take this step, can opt for a lower level of integration.

The globalisation project of recent decades needs to be reassessed. It has not only led to capital market and real estate bubbles, but also to an increase in the instability of many prices which are relevant for the global economy. Exchange rates, commodity prices or food prices have thrown the global economy into a state of shock. Since the 1980s currency and financial crises have increased and intensified in countries on the economic periphery. For countries like Turkey, Vietnam, South Africa, Hungary, Ukraine, the Baltic states, etc. the current financial crisis harbours the risk of heralding a new wave of peripheral economic crises. In the light of such turbulence it is difficult to speak of an efficient worldwide allocation of resources, but rather at best of gigantic waste. At the same time in almost all countries there has been an increase in the inequality of income and wealth distribution and a rush of precarious working conditions. The level of insecurity has increased for all economic actors – for employees, small business owners, the wealthy, financial institutions and even multinational corporations. In order to bring about the creation of a framework for regulation that can direct the globalisation process along a more stable and just track, a rethinking about new global parameters for the world’s economy is long overdue.

Information: Bureau for Workers' Activities
International Labour Office
4, route des Morillons
CH-1211 Geneva 22
Switzerland

Tel.: +41 22 799-7448
Fax: +41 22 799-6570
researchnet@ilo.org
www.gurn.info