

# **The long march into financial instability**

**by**

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## After the Great Crisis (1929-1941) ...

### A "Golden Age of Capitalism" (1946- ca. 1973):

- Unprecedented economic growth
- Low unemployment
- Low inflation
- Income distribution perceived to be fair
- Fairly stable financial markets

***The Age of  
Keynes!***

### Broad consensus:

- Manchester capitalism is passé
- Economic stability through fiscal and monetary policy
- Solid regulation of financial markets
- A decent security net

# After the “Golden Age” (1946-73) there is a turning point around 1975-1985:

- **Slowdown of economic growth**
- **Fiscal stimulation seems to become inefficient**
- **Oil price shock en “Stagflation” (stagnation + inflation)**
- **“Dutch Disease” → plant closures and mass unemployment**
- **Growing government debt burden**
- **Keynesian macro-models make tough forecasting errors**

**All this was a fruitful breeding ground for an anti-Keynesian counter-revolution from the right:**

**Supply-side economics!**

# *Supply-side economics (1):*

- **Passive economic policy: no more fiscal stimulation; only monetary policy for fighting inflation**
- **Striving for greater income inequality: "Performance must pay!"**
- **Deregulation of labor markets: easier firing! (power to the bosses!)**
- **Cutting back on social security ("it makes people passive!")**
- **Retreat of government: deregulation, liberalization, privatization; Hayek (Nobel Prize 1974): "Minimal State"!**
- **Deregulation of financial markets: more room for financial innovation!**
- **Markets are never wrong ... and government is at the roots of every problem!**

## *Supply-side economics (2):*

Also called: **NAIRU = Non-Accelerating Inflation Rate of Unemployment**

**Theory of 'Natural Unemployment' → You need a sufficiently large rate of unemployment in order to discipline labor and prevent inflation through high wage claims**



**In most OECD countries the NAIRU level of unemployment is estimated around 5-7% (less is undesirable as it might enhance inflation!)**

# Supply-side economics works: Greater inequality!

## Share in National Income in the US:

### Of the richest 10%:

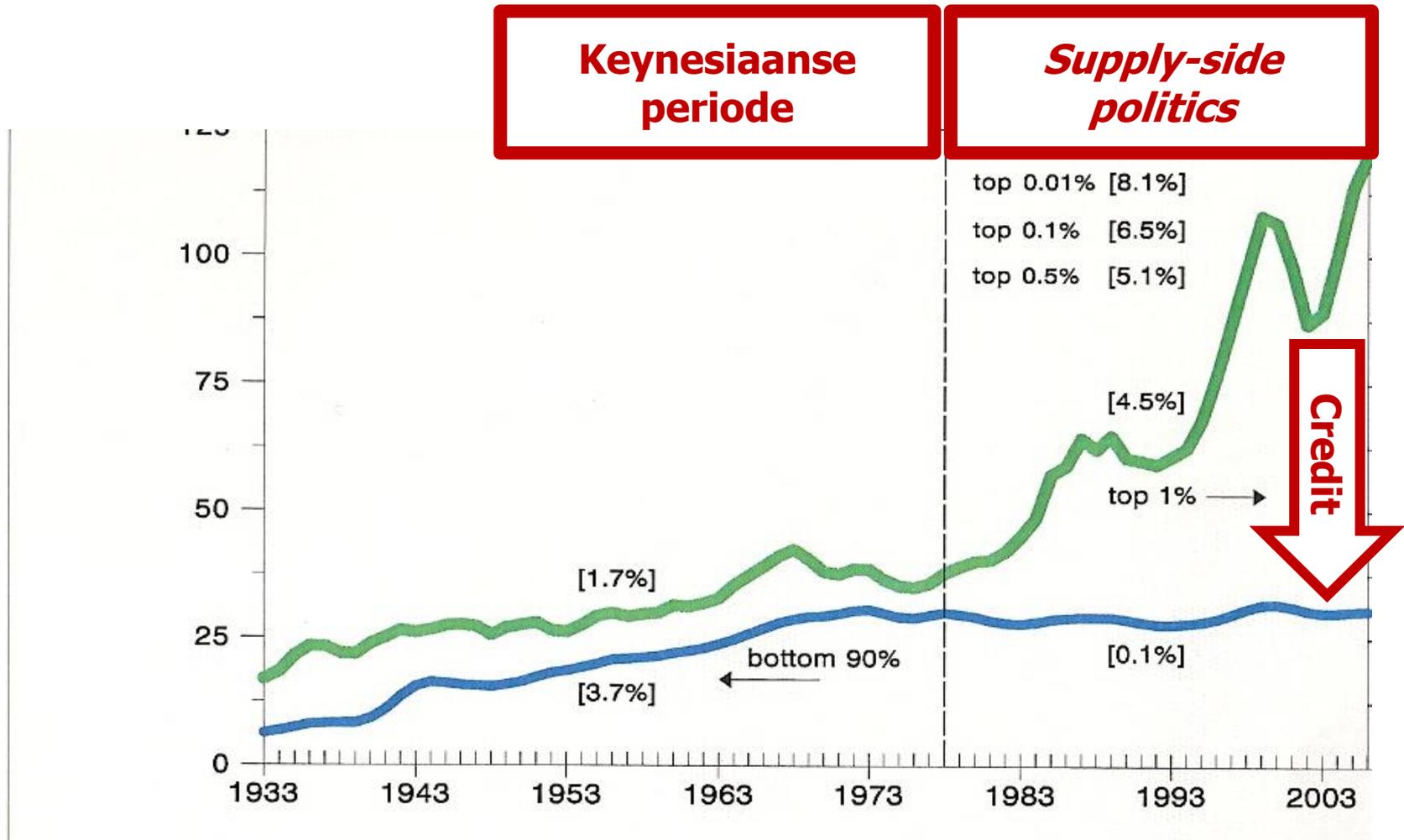
- ❑ 33% in 1976
- ❑ 50% in 2007

### ... and of the richest 1%:

- ❑ 8.9% in 1976
- ❑ 23.5% in 2007

**Source: Atkinson, Piketty and Saez (2011)**

# US: Average income of the bottom 90% and of the top 1%, 1933-2006



# What type of crisis?

- **This is a non-regular crisis of over-speculation. Such crises happen quite frequently in history, but often they are confined to certain markets or countries.**
- **This crisis is "historic" as it takes place at World-scale**

## **Historical examples:**

- **The Railway Crash 1873-5 and Great Depression 1875-1890's**
- **The 1930s depression (1929-1941)**

**N.B. Do not confuse this with the classical business cycle (of 7-9 years) or the Schumpeter-Kondratieff cycle (of 45-60 years)**

# **Building blocs of this crisis (1):**

- **Bonuses that encourage ruthless speculation**
- **Regulating authorities have become weak after a long campaign for the retreat of government, the "deregulation" and "liberalization" of markets (e.g. Gordon Brown's "Big Bang" in London City, 1993)**
- **A World-wide "savings glut" (Ben Bernanke): excess savings searching for investment opportunities is used for building up asset bubbles (petrol money; high savings of rich people).**

## **Building blocs of this crisis (2):**

- **Failure of Rating Agencies: much too optimistic ratings of bundles of mortgages (client-friendliness? corruption?)**
- **Implicit government bail-out guarantees for banks that are 'too big to fail'**
- **Risky leverage financing of speculative businesses**

# A crucial thing: “Leverage”

**An example of financing without leverage  
(silly & dull!):**

**Firm X needs 100.000 Euro as its working capital; they make 10.000 Euro profit per year.**

**Financing all that capital with equity (i.e. with their own money), the Return on Equity (ROE) is: 10%**

**Note: this firm is an ideal candidate for a Private Equity take-over!**

## More sexy: a reasonable leverage

**The working capital of 100.000 is financed as follows:  
30% equity + 70% bank credit, against 4% interest; total  
profits remain 10.000.**

**Return on Equity (ROE):**

**10.000 profit – 2.800 interest = 7.200 (net profit on Euro  
30.000 equity)**

**→ ROE becomes 24%! (i.e.:  $7.200 / 30.000 * 100$ )**

# Much more sexy: A Wall Street leverage

**The firm's working capital is financed as follows:**

**5% equity + 95% bank credit (against 4% interest; total profits remain 10.000)**

**ROE: 10.000 profit – 3.800 interest = 6.200 (you make 6.200 net profit on 5000 Euro of your own capital!)**

**→ your ROE is 124%! (i.e.:  $6.200 / 5000 * 100$ )**

**Note: Profits and capital requirements remained unchanged; only the financial structure changed!**

## Summing up:

- **As long as profits on your total invested capital are higher than interest rates, you can increase the Return on Equity (ROE) by financing with credit.**
- **The lower the interest rates and the higher the share of borrowed capital in total capital, the higher is your leverage.**
- **With higher leverages, you can offer higher returns to suppliers of equity – which means higher bonuses!**

# The risk of leverage:

**Your working capital of 100.000 is financed as follows:  
5% equity + 95% bank credit (against 4% interest);**

**Problem: your firm makes a loss of - 10.000**

**What is then your ROE?**

**-10.000 'negative profit' plus 3.800 interest = - 13.800 (i.e. you make 13.800 net loss on your 5.000 equity!)**

**→ the negative ROE becomes -276%!**

**(i.e.:  $-13.800 / 5.000 * 100 = -276\%$ )**

# Macro economic background: The import surplus of the USA

## Import surplus:

- **Exports minus imports (billion US \$):**

**Ca. 7% of US  
National Product!**

<b>1991</b>	<b>- 31,1</b>
<b>1995</b>	<b>- 104,0</b>
<b>2000</b>	<b>- 379,8</b>
<b>2002</b>	<b>- 423,7</b>
<b>2004</b>	<b>- 612,1</b>
<b>2005</b>	<b>- 714,4</b>
<b>2006</b>	<b>- 758,5</b>
<b>2007</b>	<b>- 711,6</b>

# Examples:

**Import surplus of the USA in 2006: 758 billion dollars**

**Export surplus of the Netherlands in 2006: 40 Billion Euro (ca. 7.5% of National Product)**

**Question: How is this compensated?**

**Through trade in valuable assets**

**The capital account covers trade in valuable assets (i.e. shares, bonds, real estate, art, and – more recently – mortgage-based securities)**

## **Capital account**

### **Import of capital**

**(Acquisition by foreigners of our shares, bonds, real estate etc.)**

### **Export of capital**

**(Acquisition by our citizens of foreign shares, bonds, real estate, 'mortgage-based securities', etc.)**

# **What does the current account deficit (import surplus) of 758 billion US dollars mean? (1)**

**The US have to sell every year assets (shares, bonds etc.) worth about 758 billion dollars to foreign investors in exchange for "too many" goods and services being imported**

## **Note:**

**This is a net amount: the US have to sell 758 billion more of assets than Americans buy abroad**

# **What does the current account deficit (import surplus) of 758 billion US dollars mean? (2)**

- **In recent years, US assets sold to foreigners consist increasingly of bonds (debt paper) issued by US firms and the US government – and of mortgage-based securities**
- **The growing national debt translates into debts of individual actors such as:**
  - **government (national debt),**
  - **firms (bonds, bank loans) or**
  - **private citizens' debts (mortgage debt; consumer credit; credit card debt)**

# *How long can you continue building up debts?*

**Quite long:**

**Export surpluses and import surpluses are equal to each other on a World scale → There is, by definition, enough money to lend and borrow, as long as the surplus countries are ready to lend to the deficit countries.**

**Credit, however, depends on trust ... and trust has been damaged**

## **Solutions:**

- **Americans have to consume less and save more (higher exports, lower imports)**
- **Europe and Asia have to do the exact opposite (more domestic consumption, lower exports, higher imports → lower savings!)**

## **Difficult to judge:**

- **There is a bubble of over-valued assets (shares, bonds, art objects, houses, office rooms etc.) built up through a long period of low interest rates and excessive credit (Shiller Index)**

**A prolonged 'balance sheet' crisis?**

- **Lower private consumer spending through losses on assets ...**
- **Lower investments and balance sheet reparation ...**
- **... enhanced by government austerity policies**

**Are we heading for a Japanese scenario ...??**

# Finally: Why did so many people not foresee the emerging debt crisis? (1)

- **Strong believe in stable and efficient markets**
  - **Markets are stable: they always strive towards equilibrium**
  - **Markets are efficient (welfare maximizing outcomes)**
  - **Actors are rational and act in the interest of their firm.**

**Dominance of micro-  
economics above macro-  
economics + fading  
memory of the 1930s**

***"We had to dance as long  
as the music was on!"  
(A Lehman banker)***

- **As long as a bubble is building up, there is a lot to be earned!**

# Why did so many people not foresee the emerging debt crisis? (2)

- **Long tails: If the Black Swan appears, consequences are disastrous – but the probability that it will appear is quite small**
- **An enormous build-up of debt in the US ...**

## US: Domestic debt as a percentage of GDP (1950-2007)

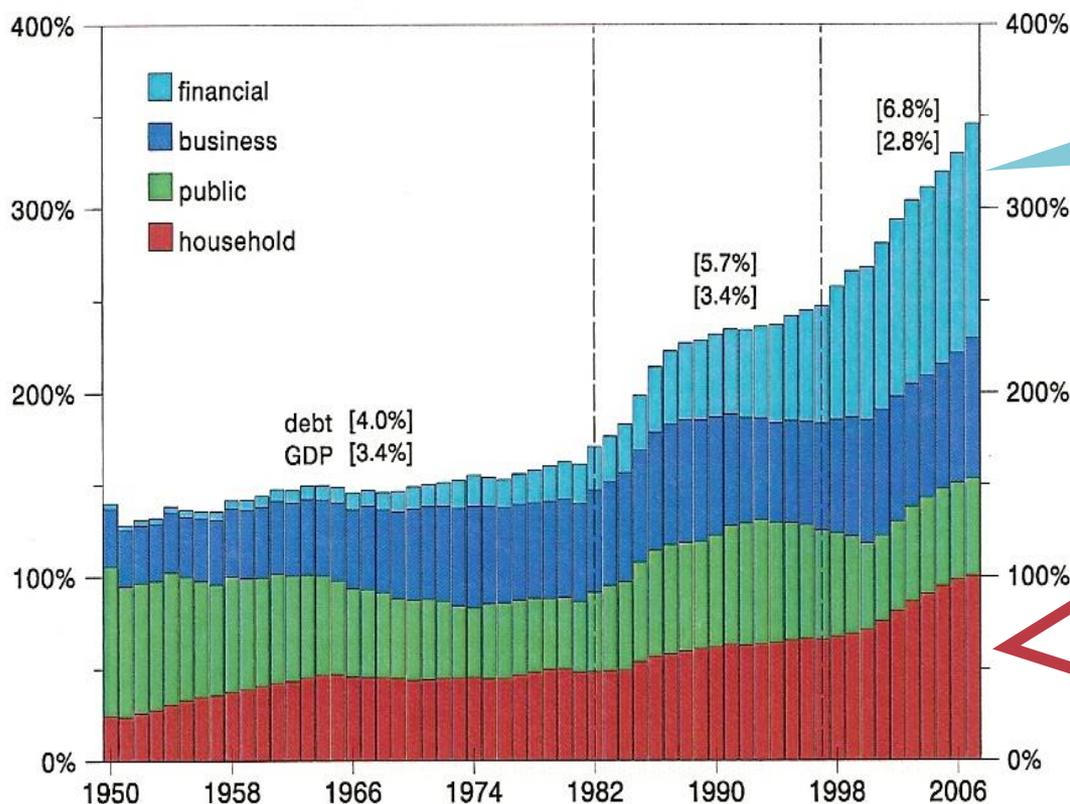
"Household" = Consumer and mortgage debt

"Business" = Total non-financial business sector debt

"Financial" = Total financial sector debt

"Public" = total public sector debt (local and federal)

Source: US Federal Reserve



Leverage financing!

Rapid rise in housing prices → higher mortgages

## **Summarizing:**

**There were strong indications of a coming crisis (for those who wanted to see them):**

- **A growing debt burden in the US: Earlier or later, the chain of credit had to brake (at its weakest link)**
- **A high value of Tobin's Q in the US stock exchange (comparable to the value in 1929!)**

**Why was this not seen (by so many 'experts')?**

**Theoretical convictions and ideological beliefs influence perception of statistical facts**



**... and many professors of finance earned good money advising Wall Street ...**

# Finally: The drama of the Mediterranean countries ...

- **After their accession to the EU, they had higher growth rates than the Northern countries!**
- **But this was only possible as they could devalue their currencies from time to time ...**
- **... devaluation makes your export cheaper, and your import more expensive**
- **... and that helps avoiding excessive import deficits**

## **The key problem:**

**Since the introduction of the Euro, devaluation is no more possible!**

**→ Mediterranean countries build up ever higher import surpluses ...**

**... and these surpluses were/are paid mainly through credit!**

# What market fundamentalist don't tell you ...

**Failing financial markets: banks gave easily credit, being blind for risks ... while the debt burden grew to dramatic heights**

**... and they failed asking risk premiums which could have discouraged borrowing ... so borrowing went on, at low interest rates, until the bubble busted**

**... and Rating Agencies were sleeping: Mediterranean countries had solid A-ratings until the weeks in which the bubble exploded!**

## **“Framing” of the political discussion:**

- **Lots of concern about governments with high debts, but little is said about banks lending too much**
- **Lots of talking about governments as easy spenders: How can we enforce budget discipline?**
- **... but there are just two countries that have a problematic government debt (Greece and Italy); in other countries, private debt is the problem**
- **Many countries reduced their government debt after accession to the Eurozone...**
- **... but debt (as a percentage of National Product) rose again after the Lehman Crash in 2008**

# An alternative diagnosis:

- **Germany and the Netherlands bring Mediterranean countries into difficulties through an aggressive export policy**
  - **Their export surpluses create lots of extra jobs in Germany and the Netherlands ...**
  - **... but destroy jobs in the Mediterranean countries: the rich steal jobs from the poor!**
  - **... and our financial sector provides cheap and abundant credit which allows them paying for their import surpluses**
- **You could already long ago see that this had to end in a credit crisis!**

# Right-wing solutions: strong austerity!



**Cuts on social security and quickly rising unemployment**



**Strong competition on scarce jobs: breaking the power of trade unions and the left ("never waste a good crisis!")**



**More political room for "Supply-side economics" →  
Remainders of the Keynesian welfare state can be  
abolished**

**Logic of the theory  
of 'natural'  
unemployment  
(NAIRU)**

## **Right-wing solutions: Deflationary policy!**

- **In Mediterranean countries, the general price level has to go down in order to make them competitive again**
- **... this requires downwardly flexible wages, defeating the trade unions and easier hiring and firing ...**
- **... but when prices decline, consumers postpone their spending, waiting for lower prices ...**
- **... which brings the economy even deeper into crisis – and this diminishes possibilities for debt-repayment ...**
- **... and unpaid debt has, in the end, to be born by European tax payers**



**→ Food for right-wing populists: “Our tax money is wasted by lazy people in Southern Europe!”**

## Alternative solutions (1):

**Hard commitments (with automatic sanctions!) that Germans and Dutch learn how to behave:**

- **More domestic consumption and lower savings in Germany and the Netherlands (=lower exports, higher imports)**



**... and the opposite in the Mediterranean countries!**

## Alternative solutions (2):

- **Trade unions should coordinate their wage claims: strong wage increases in countries that have export surpluses; low wage claims in countries that have import surpluses!**

## **Alternative solutions (3):**

- **More European solidarity: every currency union in the World has a public budget for “backing-up losers”: The rich have to support the poor!**

## **Alternative solutions (4):**

**A more generous reduction of debt through 'haircuts'. With large debt levels, potential investors do not invest as they fear:**

- **future tax increases and**
- **worsening public services through austerity**

**... and rich people in the country invest their money abroad**

**And if all this turns out impossible ... if nationalism prevails?**

**Then split the Eurozone into a Euro-North and a Euro-South with an exchange rate between them**

**... or, if that is not feasible: let individual countries exit the Euro (in a well-managed way)**

**This is damage-control for the European project → there is a risk that anti-European populists gain momentum!**

## **The real problem: how to reduce unemployment in (Southern) Europe?**

- 1. After the explosion of a major financial bubble in 2008, we may enter a longer period of low GDP growth**

(see C.M. Reinhart & K.S. Rogoff: *This time is different*, Princeton Univ. Press 2011).

- 2. ... but even if we got higher growth, we have a real danger of jobless/job poor growth, thanks to the IT revolution**

(see: E. Brynjolfsson & A. McAfee: *The second machine age*, New York: Norton 2014).

## Proposition:

- **It is most likely an illusion that, in the nearer future, high growth will drastically reduce unemployment in the Eurozone, notably in Southern Europe**
- **Persistently high unemployment will erode the European Social Model (through “structural reforms”)**



**Strong competition for jobs is destructive to solidarity → Weaker trade unions → Pressure on wages and social standards; tendency to easier firing and more ‘flexible’ labour markets**

**Proposition:**

**High unemployment in Europe has little to do with:**

- “lack of competitiveness” or
  - outsourcing to low-wage countries and
- ... it can hardly be reduced through aggressive export strategies**

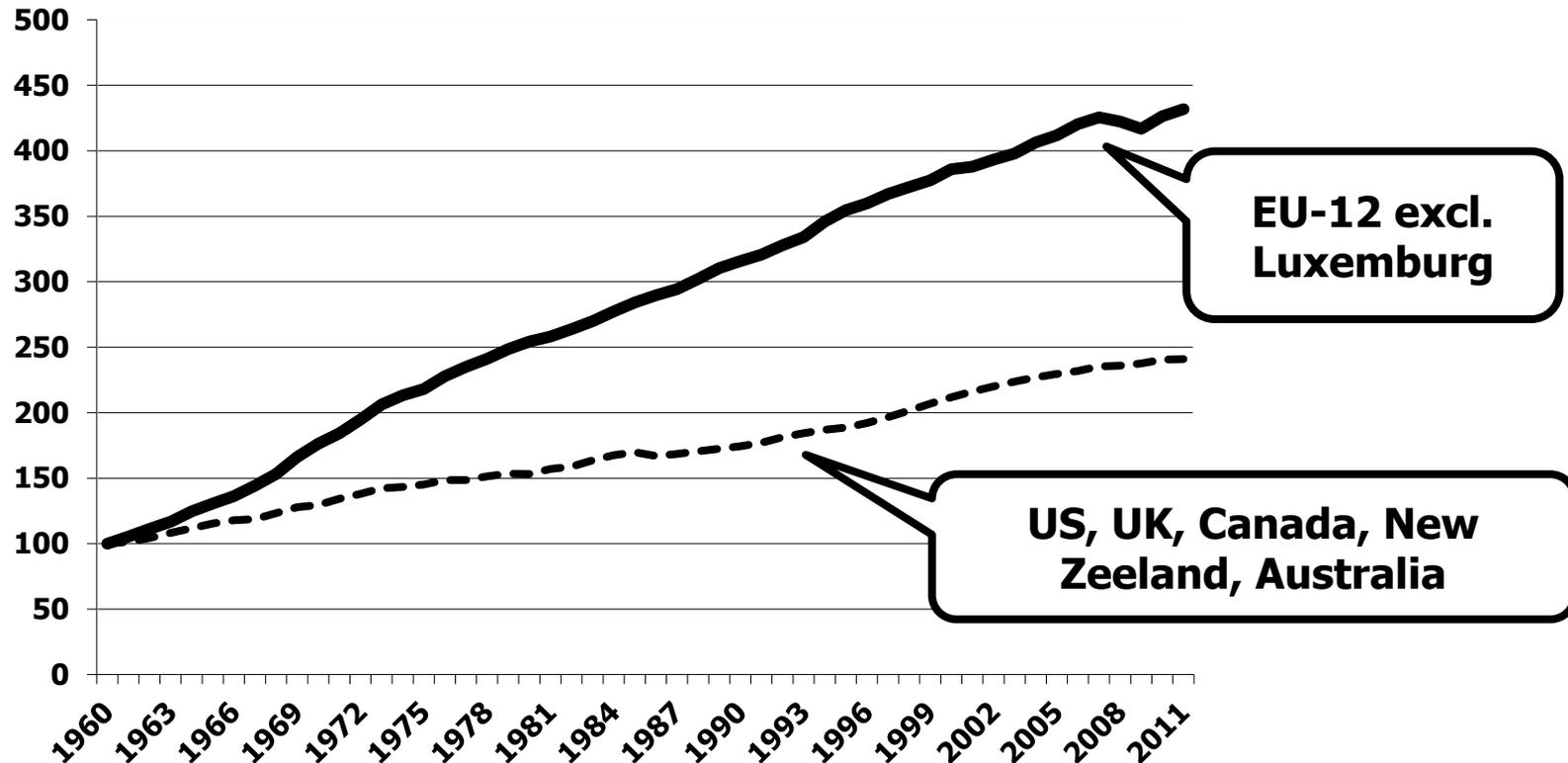
**The key problem:**

***Coordinated Market Economies (CME)* have substantially higher growth rates of labor productivity than *Liberalized Market Economies (LME)* ...**

**... and, as a consequence, CMEs have a lower growth of labor input than CMEs! (*next sheet*)**

## Old Europe's superior labor productivity performance

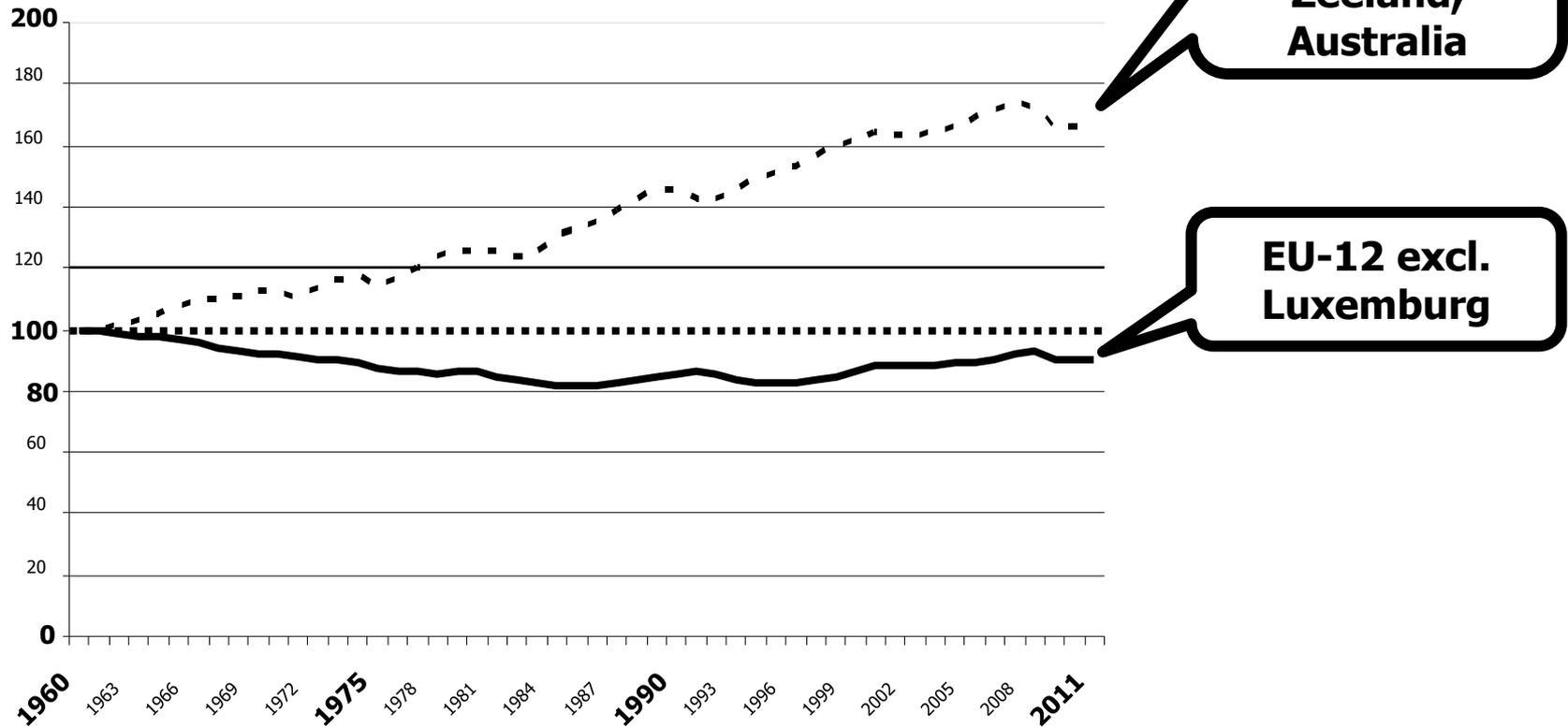
**Development of labor productivity,  
1960-2004; 1960 = 100**



**Labor productivity = GDP per working hour**

# Job-poor growth in Europe and job-rich growth in Anglo-Saxon countries ...

**Development of total hours worked  
1960-2004 (1960 = 100)**



## Long-run growth of GDP

	Average Annual GDP growth			
	Old Europe	Anglo- Saxon countries		
1950-60	5.5	3.3		
1960-73	5.1	4.1		
1973-80	2.7	2.4		
1981-90	2.6	3.2		
1990-00	2.4	3.1		
2000-04	1.3	2.5		

Old Europe: EU-12 (excl. Luxemburg)

Anglo-Saxon: Australia, Canada, New Zealand, US and UK

## Long-run growth of GDP and of GDP/labor hour (=labor productivity)

	Average Annual GDP growth		Average annual GDP growth per hour worked		
	Old Europe	Anglo- Saxon countries	Old Europe	Anglo- Saxon countries	
1950-60	5.5	3.3	4.2	3.6	
1960-73	5.1	4.1	5.2	2.7	
1973-80	2.7	2.4	3.0	1.1	
1981-90	2.6	3.2	2.4	1.4	
1990-00	2.4	3.1	1.9	1.9	
2000-04	1.3	2.5	1.1	1.6	

Old Europe: EU-12 (excl. Luxemburg)

Anglo-Saxon: Australia, Canada, New Zealand, US and UK

## Long-run growth of GDP, of GDP/labor hour (=labor productivity) and of labor hours (per 1% GDP growth)

	Average Annual GDP growth		Average annual GDP growth per hour worked		Growth of labor hours per 1% GDP growth	
	Old Europe	Anglo-Saxon countries	Old Europe	Anglo-Saxon countries	Old Europe	Anglo-Saxon countries
1950-60	5.5	3.3	4.2	3.6	0.23	-0.09
1960-73	→ 5.1	4.1	→ 5.2	2.7	→ -0.03	0.34
1973-80	→ 2.7	↔ 2.4	→ 3.0	↔ 1.1	→ -0.14	↔ 0.55
1981-90	2.6	3.2	2.4	1.4	0.07	0.55
1990-00	2.4	3.1	1.9	1.9	0.21	0.40
2000-04	1.3	2.5	1.1	1.6	0.15	0.35

Old Europe: EU-12 (excl. Luxemburg)

Anglo-Saxon: Australia, Canada, New Zealand, US and UK

### Explanations?

- Speed of adoption of labour-saving / productivity-enhancing technology (Substitution of capital for labour)
- Vintage effects
- “Creative destruction”

Empirical estimates (20 OECD countries; 44 years) show:

**A one-percent lower wage growth leads to an  $\approx 0.4\%$  lower growth of labor productivity**

### Source:

Vergeer, R. & Kleinknecht, A. (2011): ‘The impact of labor market deregulation on productivity: A panel data analysis of 19 OECD countries (1960-2004)’, *Journal of Post-Keynesian Economics*, Vol. 33 (No. 2), p. 369-404.

Vergeer, R. & A. Kleinknecht (2014): Does labor market deregulation reduce labor productivity growth? A panel data analysis of 20 OECD countries (1960-2004); forthcoming in: *International Labour Review*.

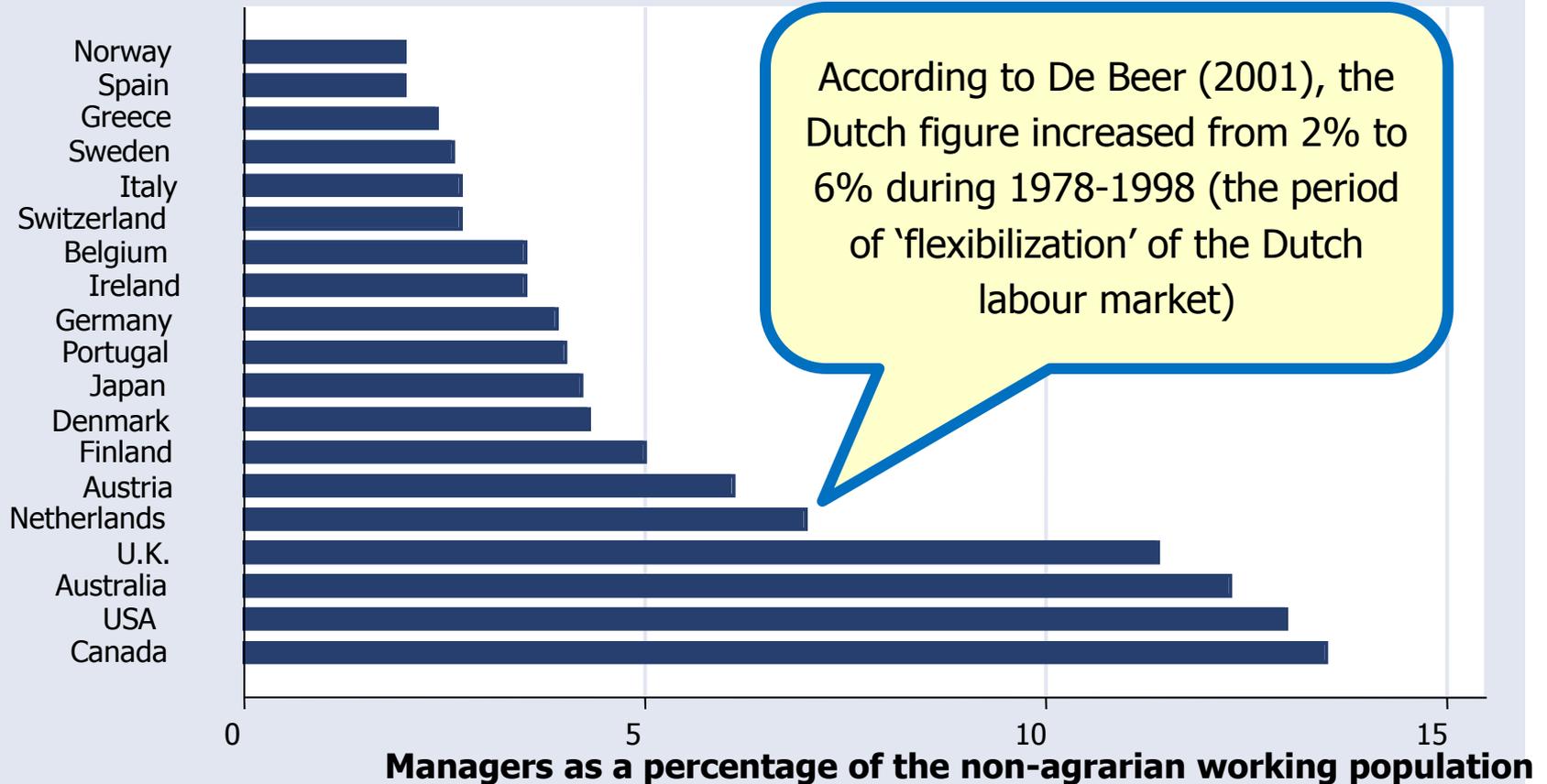
## **Why are CMEs outperforming LMEs in labor productivity growth? (1)**

**Deregulation of labor markets leads to “more dynamism”, i.e. more job turnover, which in turn reduces loyalty and commitment of workers:**

- more leaking of trade secrets and technological knowledge**
- more need for monitoring & control**
- thicker management bureaucracies**

***(next sheet)***

# Share of managers in the working population (19 OECD countries, 1984-1997)



## **Why are the CMEs outperforming LMEs in labor productivity growth? (2)**

**Deregulation of labor markets leads to “more dynamism”, i.e. more job turnover leads to:**

- **Lower investment in firm-financed training**
- **Lower benefits from “learning by doing” and weaker “organizational memories” (learning from past failures)**
- **More power for top management and less critical feedback from the shop floor → more autocratic management**

## Why are the CMEs outperforming LMEs in labor productivity growth? (3)

**Flexible firing increases risk-aversion on the shop floor: in the selection of innovative solutions, people that are easy to fire will choose less risky options → too little progression!**

Empirical support using patent and patent citation data:

Acharya, Viral V., et al. (2010): *Labor laws and innovation*, NBER Working Paper 16484. Cambridge, MA: NBER

## Why are the CMEs outperforming LMEs in labor productivity growth? (4)

- **People on the shop floor possess much of the (tacit) knowledge required for process innovations. People threatened by easy firing have incentives to hide knowledge relevant to labour-saving process innovations (Lorenz, 1992, 1999)**



**More generally, people that are easy to fire have strong incentives hiding information about how their work can be done more efficiently (exploiting information asymmetry between management and the shop floor) → in a hire & fire regime you make poor use of the (tacit) knowledge of your workers**

## Why are the CMEs outperforming LMEs in labor productivity growth? (5)

- **CMEs tend to have more centralized wage negotiations; wage increases force technological laggards to modernize equipment**
- **Other than a “Garage Business” model of innovation, a “Routinized Innovation Model” requires a continuous accumulation of (often: **tacit**) knowledge → need for continuity of personnel**

„**Tacit knowledge**“ = poorly defined, ill-codified knowledge from personal experience; hard to transfer across geographical distance; often transferred through personal interaction

<b>Schumpeter I Model ("garage business"):</b>	<b>Schumpeter II Model ("routinized innovation"):</b>
<b>Low tech firms; starters in high tech (e.g. IT)</b>	<b>Larger medium-tech and high tech firms with professional R&amp;D labs</b>
<b>Many SME/young firms</b>	<b>Stable oligopolies</b>
<b>Turbulence (many new entrants; high failure rates)</b>	<b>Stable hierarchy of (dominant) innovators</b>
<b>Properties of knowledge base...</b>	
<b>Spontaneously available, general knowledge → <u>low</u> entry barriers</b>	<b>Dependence on historically accumulated and often firm-specific (tacit) knowledge from experience → <u>high</u> entry barriers!</b>
<b>... and appropriate labour market institutions:</b>	
<b>Recruitment through external labour market</b>	<b>Internal labour markets → well-protected "insiders"</b>

This table is inspired by: S. Breschi, F.Malerba & L. Orsenigo (2000): 'Technological regimes and Schumpeterian patterns of innovation', in: *Economic Journal*, Vol. 110: 288-410.

## **Conclusion:**

**Neoclassical theory correctly argues: deregulation of labor markets (i.e. weak trade unions, low minimum wages, poor social benefits, downwardly flexible wages etc.) leads to more employment ...**

**... but they do so at the cost of low labor productivity growth ...**

**... and hence somebody needs to sacrifice income ...**

**... in practical life we get a growing class of working poor with precarious jobs (and a middle class under pressure)**

# Two alternative strategies for capitalism:

**1. Neoliberal strategy:** Flexible labor markets; easy firing; weak welfare state (“Structural Reforms”):

- Overall poor labor productivity growth (→ many jobs!)
- Many working poor
- A much more unequal income distribution

**2. European Social Model:** Rigid labor markets + strong welfare state + tough investments in education and research:

- High speed of labor-saving technical change → Many highly productive jobs for protected insiders, but:
- *Modest* overall job growth
- As a compensation: shorter working weeks

**Can fiscal policy help the unemployed?**