GLU

Global Labour Column

http://column.global-labour-university.org/

Number 14, March 2010

CSID CORPORATE STRATEGY AND INDUSTRIAL DEVELOPMENT

Global Financial Crisis 2.0

by Raymond Torres

Recovery prospects are being seriously hampered as a result of risk of a return to pre-crisis policy settings. By the end of 2009, the world economy was slowly recovering, aided by stimulus measures implemented by governments since the onset of the crisis. However, recent pressures for a return to orthodox policies in the context of an unreformed financial system threaten these fragile achievements.

Fiscal stimulus measures helped put a floor on the global crisis

The crisis led to a significant policy response by governments and monetary authorities. In advanced countries, interest rates were drastically reduced and have been maintained at a low level. Massive rescue packages to avoid a collapse of financial institutions were implemented – mainly in developed countries. And most countries that had a budget space implemented fiscal stimulus measures in the form of discretionary tax cuts, higher government spending or a combination of both. These fiscal measures were crucial to revive the economy given the weakness of monetary policy tools in a context of "deleveraging" in the private sector and among financial institutions. According to ILO estimates, the fiscal stimulus measures amounted to around 1.7% of world GDP.[1]

Overall, the measures have succeeded not only in supporting the economy but also in avoiding further significant job losses. Estimates are for an increase in world unemployment by over 20 million workers between the fall of 2008 and the third quarter of 2009, for the 51 countries for which data are available.[2] This is less than what had been feared at the start of the crisis.[3] For instance, in EU countries, the employment effects of falling GDP have been much less than was the case in earlier recessions.

This relatively favourable outcome reflects, first, the rapidity of the policy response. Research shows that, by adopting stimulus measures soon after the start of the crisis, countries could expect a significant positive impact on employment by mid-2010 (ILO, 2009). By contrast, a postponement of the measures by 3 months would delay employment recovery by 6 months –illustrating the disproportionate costs of inaction for employment.

Second, the fall in employment has been cushioned by the nature of the policy response itself, consistent with the ILO's Global Jobs Pact: [4]

- In the majority of cases, crisis responses have focused on stimulating aggregate demand. In particular, an effort has been made to enhance social protection (Brazil, India), extend unemployment benefits (Japan, US), avoid cuts in minimum wages and adopt other measures for low-income groups. These interventions, by sustaining the purchasing power of low-income groups, have effectively boosted aggregate demand while alleviating somewhat the social costs of the crisis.
- In countries like France, Germany and the Netherlands, short-time working arrangements have been aided by government subsidies. In other countries like Australia and the US, part-time employment has surged. These policies have helped reduce job losses. In the face of growing credit constraints, an effort has been made to support otherwise sustainable enterprises (e.g. in the Republic of Korea).
- Finally, in the face of growing long-term unemployment, an effort has been made to enhance active labour market policies.

Recourse to inward-looking solutions has been limited so far. A generalised use of protectionist measures has been avoided, thereby reducing the risk of a collapse of international trade and investment, which could have a detrimental impact on developing countries. Importantly, there was a risk that countries would engage in a spiral of wage cuts and worker rights curtailing in order to improve competitiveness. This would have been a self-defeating and indeed counter-productive policy, given the global nature of the crisis and the need for greater aggregate demand. In addition, attempts to make workers pay for a crisis which originated in the financial system and was preceded by a significant increase in income inequalities and falling wage shares would have been reduced public support for recovery packages.

In short, the global policy response has succeeded in kick-starting an economic rebound and the policy response had also succeeded in attenuating job losses.

… but a policy mistake was made by leaving financial systems unreformed, carrying the threat of a return to fiscal restraint and policy orthodoxy

Unfortunately, the policy response did not tackle the key factor behind the crisis, namely a dysfunctional financial system. The result is, first, that the practices that developed before the crisis will inevitably re-emerge, unless action is taken. In particular, a large share of the increase in profits has accrued to the financial sector – the financial sector's share of total corporate profit reached 42% before the crisis, up from about 25%

in the early 1980s. And the profits of non-financial firms serve to pay dividends rather than invest in the real economy. During the 2000s, less than 40% of profits of non-financial firms in developed countries were used to invest in physical capacity, which is 8 percentage points lower than during the early 1980s. Ever growing pressures for more and better returns have adversely affected wages and job stability in the real economy.

Second, the lack of financial reform is reducing the room for pursuing the job-centred stimulus measures. Indeed, insufficiently regulated financial systems make it more difficult to channel credit to the real economy –so, other things equal, the amount of fiscal stimulus needed to achieve economic recovery is greater than in the presence of a well-functioning financial system.

At the same time, insufficiently regulated financial systems tend to penalize governments that run larger fiscal deficits. As a result, there is a growing risk that governments prematurely remove the fiscal stimulus measures that helped avoid a deeper recession. Governments may feel they have to reduce quickly fiscal deficits in order to appear as credible as possible in the eyes of financial markets and reduce the risk of speculative attacks. This is illustrated by recent events in the Euro area: even countries with much lower public debts than Greece have had to adopt in haste fiscal packages that reassure markets. Importantly, an unpublished study by Reinhart and Rogoff on "growth in a time of debt" suggests that such moves lack economic foundation in countries where public debt is significantly lower than 90 per cent of GDP.

In addition, the type of fiscal restriction measures which are presently considered tend to focus on spending cuts, in particular in the area of social policy, rather than higher government revenues (including through vigorous fight against tax competition and tax fraud, and consideration of new revenue sources like green taxes). The risk is that welfare benefits, which proved so essential to ensure adequate income support to the innocent victims of the crisis, be cut. This would erode political support for the crisis response strategy, possibly leading to social unrest. In addition, by scaling back certain programmes, many jobseekers will be pushed out of the labour market, depriving the economy from valuable resources. Keeping well-designed programmes is in fact cheaper over the long term, given the favourable effects of these programmes on participation and skills.

Fiscal measures are still needed because the real economy is too weak to have gained an autonomous growth momentum, at least in developed countries where the process of "deleveraging" is far from finished.

In addition, countries also tend to move quickly to export-oriented strategies in order to improve the current account balance and build up foreign exchange reserves, thus reducing perceived risks for financial operators. The problem is that some countries have to import in order for others to export – and the US cannot remain the importer of last resort. Therefore, a quick return to export strategies would end up reducing the prospects for world trade and economic growth.

Altogether, we may be entering a new stage of the crisis where financial markets are adding pressure for an early exit from fiscal stimulus measures and for cuts in social protection and wages. This would strongly affect the world economy given the weak autonomous growth capacity of the private sector –partly due to continuously tight access to bank credit. It would also further prolong the employment recovery and erode social support for governments' crisis strategies.

It is urgent to move ahead with the reform of the financial system while ensuring job-centred fiscal stimulus.

Rescue packages to financial institutions have reached unprecedented levels in countries where the crisis originated. The bill will be expensive for taxpayers and job losers. It is therefore essential to ensure that an end is put to those financial practices and irresponsible risk-taking that preceded the crisis. As noted by the BIS in its 2009 annual report, "a healthy financial system is a precondition for sustained recovery. Delaying financial repair risks hampering the efforts on other policy fronts".

True, the financial industry has undertaken steps to modify its practices through the adoption of codes of conduct and other non-binding initiatives. But there is concern that new regulations will push the financial industry to other locations. The overall impression is that, unless action is taken soon, business-as-usual will prevail. In such an unreformed context, the practices that provoked the financial crisis will resume soon after economic recovery starts. The pressures would aggravate the situation in a deteriorated world of work, while raising the risk of later crises.

There are various options that can be considered in this respect. What is important is to address the root problems, in particular i) inadequate and incomplete regulation, and ii) inappropriate incentives for risk-taking and pay of bank executives and traders.

For the reasons outlined above, the approach should be as coordinated as possible –at least at the level of the G20. Otherwise free riding problems will inevitably arise. This, together with proper implementation of the Global Jobs Pact, will support economic recovery in the short run, while paving the way for a more sustainable world economy.

[1] *ILO (2009), The financial and economic crisis: a decent work response, Geneva*

[2] *International Institute for Labour Studies (2009), World of Work Report 2009: The Global Jobs Crisis and Beyond, Geneva*

[3] *ILO (2010), Global Employment Trends, Geneva*

[4] *ILO (2009), Recovering from the crisis: A Global Jobs Pact, Geneva.*

Raymond Torres is the Director for the International Institute for Labour Studies at the International Labour Organization. He recently launched the World of Work Report, the new annual flagship publication from the Institute.