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Economic Stagnation Postponed
Background to the 2008 Financial-Economic Crisis in the European Union and the United States

Abstract: The significant increase since the early 1980s in the share of income accruing to capital (rather than labor), in both the United States and the European Union, created the potential for economic stagnation. Stagnation was postponed, however, by the development of the banking sector in these countries, notably in the increasing amounts of credit granted to wage earners. To the extent that such lending will be curtailed in the aftermath of the recent financial-economic crisis, stagnation looms. Within the confines of capitalism, this dilemma can be overcome only by making a significant shift in the macroeconomic pattern of income distribution to realign consumption with income. While particular banks and banking policies are usually blamed for the crisis and indeed played an important role, the roots of the crisis are located at a deeper level. The implication is that the economic problems we face will be much more difficult to overcome than the usual analyses suggest.

Key words: expenditures, macroeconomic distribution of income, monetary circuit approach, stagnation

Though the development of the banking system in the decades before 2008 postponed the economic stagnation that should have resulted from the divergence

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between income and consumption, a prolonged period of near-zero growth now threatens to materialize in the aftermath of the financial-economic crisis.

The capitalist system comprises many elements and contradictions that cannot be eliminated or overcome within that system. These include the monetary value and profit criteria for production, as well as the trading of labor-capacity (and therefore the capital-labor opposition) that are the cornerstones of capital accumulation. By contrast, in this author’s view, economic stagnation or banking crises are not necessarily inherent to capitalism (although they are certainly not unlikely). That said, the elements outlined below that characterize the development of capitalism in the United States and the European Union were gradually built up over a period of thirty years and have thus become entrenched. Therefore, while they might be overcome within that system, in practice this would be difficult and take time. The analyses and proposals presented in this brief paper remain within the strictures of the capitalist system.

The Gap Between Profits and Investment

This section first briefly indicates the determinants of surplus-value realization and profits. For the purposes of this paper, surplus value realized \( (SVR) \) is defined as total company profits \( (R) \) plus the net interest companies pay to financiers, including banks. Hence \( R = \text{retained company profits plus dividends} \). (All equations and numbers in this paper are macroeconomic.)

\[
R + \text{net interest paid by companies} = SVR
\]  

(1)

The discussion in this section neglects government and the foreign sector. Given production and the determinants of the production of surplus-value (not treated in this paper), the realization of surplus-value is determined by the macroeconomic expenditure categories of investment \( (I) \) plus consumption \( (C) \), minus wages \( (W) \), all in monetary units:

\[
SVR = I + C - W
\]  

(2)

This is a Kaleckian type of equation, in which the determination is read from right to left (that is, expenditures determine realized surplus value).\(^1\)

It is often expected that increasing profits are an incentive for increased investment. However, when we consider the era of so-called neoliberalism (from about 1980) for the United States and the EU-15 countries, the data show the opposite.\(^2\) The two bottom lines of the graphs in Figure 1 show profits (including interest) increasing while investment decreases. Both are measured in shares of the gross domestic product (GDP).\(^3\)

As capital’s share in total income increases, its share in labor income decreases. This paper does not expand on the reasons for this change in income distribution, which relate to developments in the labor market and the production aspects of income determination.\(^4\) In short, the enduring, widespread unemployment that followed the 1981–82 recession shifted the balance of power between companies
Figure 1. Macroeconomic income and expenditure shares in GDP: EU-15 and United States, 1960–2010

and labor, such that wage increases could continuously be held below increases in labor productivity.

**Components of the Gap Between Profits and Investment**

How can the increasing gap between profits and investment be explained? The key lies in consumption and wages. Rearranging equations (1) and (2) gives:

\[ R = I + C - (W + \text{net interest paid by companies}) \]  

(3)

Since the early 1980s, the wage share of GDP in the EU-15 has significantly declined, for a total of about 10 percent (see Figure 1 to trace this development over the past fifty years). At the same time, however, the consumption share has remained roughly constant. In the United States, this development is even more dramatic: the wage share declined in combination with increasing consumption, giving rise to a gap of about 10 percent between income and consumption.5

**Declining Savings from Wages**

These changes can be explained in part by the macroeconomic decline in savings from wages (a decline in the flow of savings) implied by the difference between wages and consumption, as shown in Figure 1. In the European Union, this difference was near zero around 2010; in the United States, the macroeconomic savings rate was already nearing zero around 1980. As explained below, such a situation favors companies.

The monetary circuit approach shows that the initial financing for investments and wage payments is provided by bank credit. Figure 2 (streams 1–2–3) shows wage payments financed by a flow of bank-provided credit, called here “pre-validating finance” (PVF), and represents the “case” of savings by wage earners (stream 5–6). In such a case, companies accumulate a stock of bank debt in an amount equivalent to wage earners’ savings. There is thus a triangular creditor-debtor relationship among banks, companies and that is generally favorable to banks in terms of interest margins and detrimental to companies, not only because wage earners spend less, but especially because companies continue to accumulate a stock of debt.6

It can be seen from Figure 2 that, all other things being equal, when wage earners save less (and spend more), companies accumulate less debt and their interest payments decline (see Equation 3). At the same time, banks lose on this front: declining savings from wages affects the distribution of surplus-value between banks and companies, increasing the latter’s share.7

**Colonizing the Future**

The next step moved consumption beyond wages. It is well known, of course, that this was financed by direct consumer credit and mortgages (indirect consumer
credit), the latter being extended on the basis of collateral that was expected to increase in value. For the first time in history we saw consumption being financed on a massive scale by banks, then transferred in securitized form to wealthy portfolio investors, mostly through hedge funds. This enabled wage earners to compensate for what they had lost on the wage front and prevented the stagnation of aggregate demand, though this was not the goal.

However, loans require interest and must, at some point, be repaid. Hence the banks, as well as other financiers through the banks, made claims on wage earners’ future wages, which Photis Lysandrou has aptly called the “colonization of the future.”8 Because this “colonization” reduces future spending, it postponed stagnation.

**ConjunctiOn of Interests**

Until about 2007, the elements that contributed to stagnation postponement seemed to fit together.9

First, companies directly benefited from postponing stagnation. Once wage moderation was implemented, wage growth lagged behind increases in labor productivity, savings from wages decreased, and spending increased, which decreased company bank debt. (As indicated earlier and shown in Figure 2, PVF can
increasingly be repaid through consumption by wage earners.) In addition, once wage earner-consumers spent the consumer credit that they obtained from banks with companies, that consumer credit replaced PVF. Consumers thus provided companies with a share of the credit that banks “normally” would have provided to companies, as illustrated in Figure 3 by stream 1-2-3 (consumer credit and the spending of it) and stream 4–5 (PVF), which was stream 1-2 in Figure 2. In short, companies paid lower wages and less interest. Note that Figure 3 shows the simple case of the immediate repayment of consumer credit with wages (stream 8–9). In this case, consumer credit replaces PVF. In fact, such repayment was and remains postponed, leaving wage earners with bank debt and a “colonized” future.

Second, what banks lost in interest from companies (their share in surplus-value) they gained in interest from wage earners (their share in wages), usually with bonus interest (a higher margin). Moreover, banks received commissions for the mortgages they resold through securitization.

Third, the banks’ securitization of mortgages provided an outlet for wealthy financiers seeking portfolio investment opportunities. Thus in the relatively short period from 2000 to 2007, the value of securities issued by banks in the United States and the European Union quadrupled, increasing from $40 trillion to nearly $160 trillion.
Companies were thus direct beneficiaries of this consumer credit constellation. What about banks? Even though their activities postponed stagnation, it was probably not in their interest to finance the difference between wages and consumption (this is not a reference to the financial crisis: in that respect, it was clearly not in their interest).\(^1\) Perhaps they did not foresee that significant increases in consumer credit meant widespread substitution of consumer debt for PVF, which is more or less stable and generally more reliable. In fact, the normal PVF increase (i.e., the increase in PVF “normally” associated with economic growth) slackened. By substituting consumer debt for PVF, banks created a minefield of risky assets.

Moreover, once the process of substitution was well under way, not a single institution—no central bank or other supervisory authority, nor any government—tried to stop it. States had declared the “independence” of central banks, while central banks (connected to commercial banks through personal ties) had declared “self-regulation” for commercial banks. Commercial bankers may not have attended the meetings of the Basel Committee on Banking Supervision, but they were important consultants to the committee so contributed to its weak supervisory “framework” and even weaker supervision.

**Progress of the Crisis**

The progress of the crisis itself is not particularly difficult to follow, and has been detailed at great length in the literature. Because most banks had weak assets, they began to distrust each other. Once some of the main banks began having real trouble (i.e., insurmountable debts to other banks), this distrust spread around the world (with greatest effect in the United States and the European Union) and the banking system as a system of money transfer (payments) nearly collapsed: banks did not want to receive payments from other banks because they considered such payments to be risky debts, and states ultimately had to nationalize or semi-nationalize major banks to preserve the payment system.

In sum, companies and banks had no choice but to accept reduced profits, while the portfolio investors who had purchased securitized loans were the least affected because banks had generally provided off-balance-sheet guarantees. Those who suffered the most were the increasing numbers of the unemployed, followed closely by those who were still employed but faced wage cuts and lower living standards through cuts to state-provided welfare.

**The Problem of Stagnation Remains**

The financial and economic crisis is the manifestation of the reaction to the substantial shifts in income distribution that began in the early 1980s. However, the crisis does not solve the problem of potential stagnation. On the contrary:

If banks are not subject to more effective regulation than is currently proposed,
the banking system risks renewed collapse. A new round of massive state assistance is less likely not only politically, but also economically, as it seems beyond the means of many states (i.e., beyond the means of the taxpayer). If banks are regulated, stagnation will no longer be postponed: (1) The GDP share of consumption will substantially decline as consumer credit stagnates and plays a lesser role in financing consumption. (2) In addition, the colonization of future wages will also cause a decline in the GDP share of consumption. (3) A decline in consumption will slow investment by companies. (4) Reliance on China and India is not a likely solution. Such countries will not allow the United States or the European Union to boost their exports without equivalent imports. In sum, the U.S. and EU economies are likely to enter a period of stagnation.

What to Do?

Stagnation affects profits and the rates of profit. To prevent stagnation, the overall share of wages in GDP would have to rise considerably. To begin with, wages should at least keep up with increases in labor productivity. If companies wish to prevent further (and worse) crises, they will have to accept rates of profit far lower than those seen in the past decades. Rates of profit norms are, after all, mere conventions. A considerable increase in the share of wages in GDP is in the interest of wage earners as well as in the collective interest of companies.

In the individualistic market system, the big question is how such a radically new consensus would form? For one thing, it would necessitate a major turnaround in the attitudes of employers’ federations toward wage negotiations. If such a turnaround does not come forth spontaneously, the U.S. and EU member-state governments could try to achieve a similar result through distributive taxation. In this regard, the most efficient course of action would appear to be to decrease taxes on consumption (e.g. value-added taxes) and replace them with increased taxes on the wealthiest (financial capital/property), while concluding international taxation treaties to prevent capital flight.

This would require a momentous transformation of the political-economic “wisdom” of neo-liberalism. If the wheels of political-economic change do not turn of their own accord, stagnation might force them to turn.

Notes

1. This Kaleckian equation is analogous to the Keynesian equation of: \( W + \text{Profits}\) (broad) = \( Y = C + I\).

2. The EU-15 are the fifteen countries that made up the European Union until 2004. This group is useful because much of the relevant data dates back to 1960.

3. Investment is gross investment by companies, and capital income is the gross operating surplus (including net interest). Capital income and wages have been adjusted for wages assigned to independent producers. For the data, see the EC/Eurostat AMECO database: http://ec.europa.eu/economy_finance/db_indicators/ameco/index_en.htm (accessed April 30, 2011).
4. There are four determinants for the distribution of income: (1) the labor market; (2) production; (3) price setting; and (4) expenditures.

5. Given the number of people involved, only a very minor part of the increase in consumption can be attributed to increased consumption from surplus-value (profit and interest incomes).

6. Of course, after initial bank financing, wage earners might substitute for banks and reduce companies’ bank debt by buying company bonds, for example, either directly or indirectly (such as through pension funds).

7. Where other financiers have taken the banks’ place with respect to a portion of the debt (i.e., acquisition of the share of PVF still due), it is of course these financiers that receive a smaller share of surplus value.


9. This is not to suggest that financing the difference between wages and consumption was the subject of concerted action, but merely to indicate that there was a temporary convergence such that no interest group had a motive for behaving differently.

10. Note that if companies themselves (or specialized branches thereof) provided consumer credit, they would require PVF to do so. Such a case is therefore a subset of the case shown in Figure 3.


12. See Lysandrou, Global Inequality and the Global Financial Crisis, for further discussion.

13. It may, however, have been in the interest of bank directors and fund managers who received extraordinary bonuses.

14. Additional and widespread “deepening investment” might, in principle, keep up investments, but there seems to be no market incentive for such investment to occur at just the right time and in large enough amounts. An obvious field for such investment might be that of alternative energy, with the “market” incentive being a heavy tax on conventional energy. The problem with such a solution is that this would further depress consumption in the decades to come and thus depress the nondeepening investments. Such a program of deepening investment would have to be combined with intensification of the measures discussed in the next section.