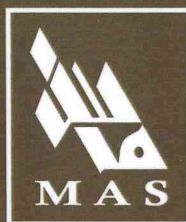
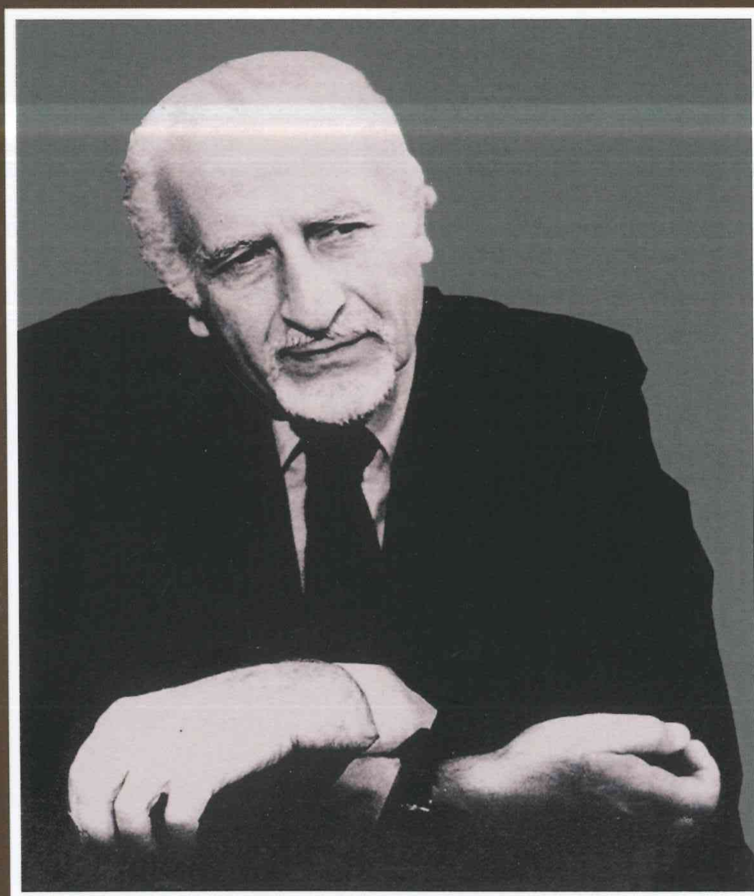


Palestine Economic Policy Research Institute (MAS)

The Yusuf A. Sayigh Development Lecture

Yusuf A. Sayigh Development Lecture is an educational and advocacy event to commemorate the contribution of Professor Yusuf Sayigh to Palestinian development studies. The Lecture is organized by the Palestine Economic Policy Research Institute (MAS)



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The Yusuf Sayigh Development Lecture 2017

"Economic Policy in a New Age of Liberalism – Radical Rethinking Is Unavoidable"[1]

Delivered by

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[1] This text is an adapted version of the YSL 2017.

Developing countries rarely care about theoretical developments in economics. They consider the main theoretical framework that isever hardly questioned by the majority of economists and politicians in the North as a given. Why should anyone in a developing country dare to question policies that have been implemented for long periods of time and therefore seembeyond question or critique? It is in this way that most economists of the developing countries accept the theories and the policy tools which are rightly called the "Washington Consensus." For a long time, the Washington Consensus was so dominant that it was almost impossible to question its apparently obvious 'rules.' The Consensus was, quite simply, the only game in the global village.

One of its most important rules concerns monetary policy and how it should be implemented literally anywhere – local differences do not matter. For many decades, the IMF based its recommendations on a theory which is called monetarism. Monetarism had the practical advantage that its guidelines could be put into practice immediately. All that is necessary is the monetary basis for it - or any other quantity of money - a projection about growth potentials and a political system which implements the proper monetary rules into the economy. However, the world is not as simple as monetarism has it. After a very short period in which it was dominant, many western countries began to abandon its ideas completely. The United States pioneered different approaches back in the 80s of the last century.

Today, monetarism is not only dead according to leftist economists. It has been completely abandoned by Central Banks all over the world. Neither the ECB nor the FED nor the Bank of Japan nor the Bank of England stilluse monetarism as a basis for their policies. Unfortunately, to the developing world monetarism is still being sold as the only available and correct macroeconomic theory.

This is one of the contradictions we have to live with. The famous phrase of an American diplomat advising developing countries is typical: "do as we say, but don't do as we do". It is crucial to understand the underlying logic: the US government has fully abandoned monetarism, but the IMF nonetheless continues to preach and implement it all over the developing world.

Crucially, developing countries need to address this contradiction during international discussions, unless they prefer to remain the intellectual slaves of the Washington consensus. Here is another important example. Everybody in the West would say that growth is the result of so-called structural reforms - whatever this may be. Despite the fact that nobody knows exactly what it is, it is used as a mantra in policy debates all over the globe. The most important component of these 'structural reforms'is always the same. It is as straightforward as it is monotonous: labour markets need be made more flexible. I will ask a very simple question: are labour markets flexible in the Western world or in the North in general? If they have become more flexible of late, did the general situation improve? The clear answer is that making labour markets more flexible is not working at all. Just as in the case of monetarism, there is a strong contradiction between the narrative for the developing world and the one for the north.

My third point is the least well understood of all. The Washington consensus demands that governmentscontain and cut their deficits. Something close to zero is seen as ideal. In reality, things are far from simple, because government deficits are connected to both trade balances and the savings positions of the economics sectors in the country. I will demonstrate this by taking my own country, Germany, as an example.

Let us have a look at some of the empirical results that we can find in the Western or Northern world to prove that things are not as simple as the Washington consensus tries to make us believe.

The evolution of GDP in Europe and GDP in the United States reveals a glaring difference. In the US, growth has picked up, and, although the recovery remains weak compared to previous cycles, it is clearly superior to the European performance. The European development is a complete disaster.Europe has had no new growth at all since the end of the recession. Why is this? Are our

structures insufficiently flexible? Are our wages too high? Are our government deficits too high? Even in Germany, growth is very modest.

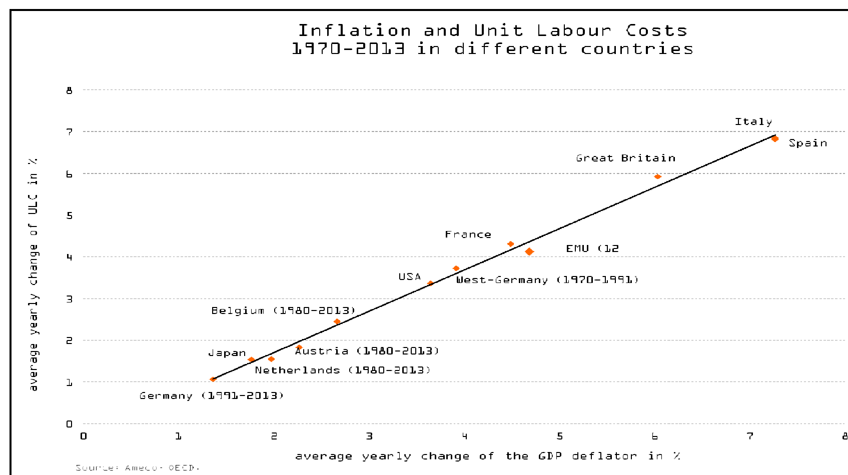
These are questions that the developing countries need to ask. Do politicians and experts from the North implement their own theories at home? If not, why not and if so, why do they fail? Unemployment remains unacceptably high in Europe. How can it be explained that Europe is being unable to bring unemployment down a full seven years after the financial crisis of 2008/09? Is it due to rigid wages? Is it due to inflexible labour-markets in France and Italy and many other countries?

These questions really matter. When the IMF tells developing countries that they have to make their labour market more flexible and cut wages, the developing countries should ask why cutting wages in Spain, Portugal and Greece failed miserably to bring back growth and unemployment. But what about Germany then, many would ask. Germany had indeed been extremely successful because it cut wages, but the fact of the matter is that the truth is much more complex than just wage cutting. It is correct to say that the German government put pressure on the unions to agree to wage cuts. In this, it went further than any other country during the first years of the new century. What is happening today? Is Germany successful? The German example constitutes no proof for the thesis that wages need to be flexible and that labour markets need to be liberalised. There is no evidence for this whatsoever.

Inflation and Wages

Let us first considerthe traditional theory of inflation. What are the determining factors ofinflation in the Western world? Look at Japan. Japan by now has unsuccessfully fought deflation for nearly 25 years. Is this due to misguided monetary policies? Is it due to the fact that the Bank of Japan was not able to inflate the volume of money? The answer is clearly 'no'. In the Western world, the only strong evidence ever found strongly supports the thesis that inflation is not related to the money aggregates (the volume of money). Instead it is closely correlated to wage evolution. The strongest correlation is between unit labour costs and inflation. Unit labour cost is the margin of nominal wage increase over productivity. If productivity increases by 5% and nominal wages rise by 7%, unit labour cost rise by 2%. All over the world, unit labour cost is moving perfectly in line with inflation.

Chart 1: Unit labour costs and prices



This is true for all regions of the world, for the United States as well as for Europe and the developing countries. The lesson to be learned here is extremely simple and straightforward:

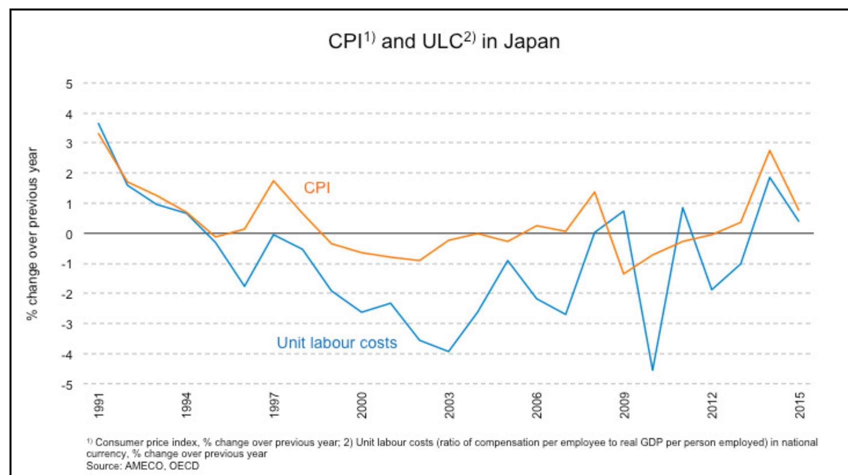
inflation is not determined by the quantity of money. It is, instead – in the longer term –, determined by unit labour cost.

Wages and Unemployment

This insight is extremely important, because if unit labour costs determine inflation, wages cannot at the same time determine employment. Real wages do not determine employment and unemployment. The reason is that if falling nominal wages lead to falling prices in the medium term, real wages will not change and if real wages will not change they cannot determine the evolution of employment.

There is no doubt that neoclassical theory is wrong. There is no such thing in this world as a neoclassical labour market. Let us consider Japan as an example. Nominal wages (the compensation of employees) have been falling in absolute terms for most of the time since 1998 in Japan. They have found their way back above the zero line only recently, although growth rates are below one per cent. Unit labour costs (the compensation per worker divided by Gross domestic product per capita) are, clearly, the best predictor of inflation in all developed countries of the world, including Japan. They have been falling consistently since the mid of the 1990s. Labour unit costs remained above zero only in years of sharp economic downswings and falling productivity. Real wages have been on a random walk below and above the zero line. The latter situation was associated with periods of absolutely falling prices and increased uncertainty.

Chart 2: Wages and Prices in Japan



Non-monetarist inflation theories of demand pull and cost push analytically and empirically clearly prove that monetary policy is powerless against the deflationary forces of falling costs in the overall economy and sluggish demand from consumers. Deflation, diminished expectations and the uncertainty of Japanese private households about their future income prevent private consumption from taking a lead role in a recovery. It is absolutely misleading to call such a situation a 'liquidity trap.'

The trap is, in effect, much more a wage trap or an income trap than a liquidity trap. It is exactly at this point that the Japanese example turns into a more general pattern about the dangers of overly flexible labour markets. This has been clear everywhere, in the US and to large parts of Europe since the outbreak of the crisis of 2008. The trap is usually triggered by sharply rising unemployment that is unrelated to specific labour market developments, such unreasonably high wage increases.

The financial crisis and the high unemployment that resulted provided the ideological justification for policies that cut wages and incomes, although wages and incomes were already depressed before the outbreak of this crisis. High unemployment together with the attempts by workers'to price themselves back into the flexible markets' as the OECD once put it, create the conditions for a perfect storm that is still raging today, a full eight years after the outbreak of the financial crisis (see for the quote UNCTAD, 2012, Chapter VI).

There is only so much that monetary policy can do. It can bring interest rates to zero or make them negative and it can implement quantitative easing (QE). After this, the possibilities monetary policy are exhausted. This has been the case for several years. What we need, therefore, are fiscal policies: huge stimulus programs that overcome the reluctance of consumers to spend in the face of their uncertain outlooks on jobs and wages. Today, in the US as in Europe, investment is restricted by low demand as a consequence of income expectations of private households at very high levels of unemployment. It is, in its most basic form, a consequence of a dysfunctional labour market in which it is possible for unemployment to sharply rise without wages being "too high". It has to be emphasised that, without completely discarding both, the monetarist inflation theory and the neoclassical labour market theory, offer no logically consistent and critical theory of economics.

Let us have a look at another major economic power to clarify this point. The United States are struggling to get out of the recession for exactly the same reasons as in Europe. Since 2008, low wage shares and an already long history of stagnating wages for middle class workers coincide with dramatic rises in unemployment. The power in labour markets has clearly shifted towards employers, but for no good reason. In fact, what is needed is a power shift in the other direction in order to restore the proper balance of power between employers and workers' representatives. Since this is not the case, high unemployment continues to depress wages. Depressed wages stifle private consumption and a lack of sufficient consumption prevents the economy from recovering, although in the meantime enormous profits are being made by companies and monetary policy is desperately trying to stimulate investment. Monetary policy can 'bring the horse to the river, but it cannot make it drink.' The only way out, without resorting to unconventional instruments such as income policies, lies in the direct improvement of labour market conditions, which can only be achieved by an extremely huge fiscal policy stimulus, but this is blocked for political reasons.

What we see, therefore, is a global disease. Large parts of Europe have been heavily infected. In the countries of the European Monetary Union (EMU) which have been most affected, extremely high unemployment has gone in tandem with absolute cuts in income for the working population, decreasing social benefits, pensions, etc. Instead of creating new growth and unemployment, falling incomes for the general population depress domestic demand and increase the level of unemployment even further. It is clear that the neoclassical cure for the labour market destabilises the overall economy everywhere when domestic demand is more important than external demand. This is true for all southern European countries and for France.

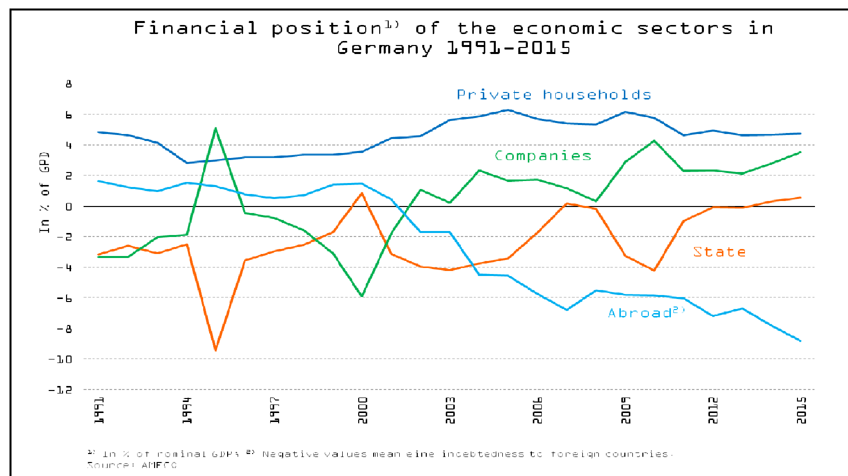
The traditional way to get around the brutal logic of destabilizing labour markets is to hope for improved competitiveness of the economy as a whole and to increase exports (or decrease imports). Indeed, if a wage cut quantitatively stimulates foreign demand more than it depresses domestic demand, a solution seems to be at hand. This, for example, explains the paradoxical case of Ireland. With an export share of over one hundred per cent of GDP, the positive effects of wage cuts on exports and imports have balanced out the negative domestic demand effects.

The problem is that all of us may well wish to be net exporters, but this will remain impossible as long as we do not find new planets which are willing to accept current account deficits and the uneasy positions of debtors. That is why the biggest country in the EMU, Germany, now faces a problem that is similar to the one of Japan. Germany has the highest current account surplus in the world, but its European partners are suffering, few are willing to accept further deficits and debtor

countries ran out of steam all over the world. It is clear that the German mercantilist approach has hit the wall.

Due to many years of wages lagging productivity growth, Germany nowadays has the lowest wage shareever since the end of the Second World War. Its private households have persistent net savings. Recently, the German government incorporated a new article into constitution that forbids the accumulation of public debts. The company sector is sitting on enormous amounts of profits and is therefore also a net saver. This is the consequence of the export bonanza of the last decade. Unfortunately, domestic investment which would correspond to the domestic net savings is nowhere in sight.

Chart 3: Financial positions of different sectors



In Germany, as in Japan, the way out without taking on new government debt is to make the company sector accept its role of being the natural counterpart of high private net savings. Economic policy has to intervene in order to increase wages and raise corporate taxes. The result of these policies should be more investment, not less. While this may sound perplexing and paradoxical to some, themacroeconomic logic (or, if you prefer, macroeconomic bookkeeping) behind it is irrefutable. If major countries such as Japan and Germany will be incapable of dealing with trading partners that are willing to go into debt, their economies will collapse sooner or later because the premise on which their economies is built is unrealistic and unsustainable. If government debt is considered to be unsound and has to be kept in check, the company sector both has to be the net debtor and the main investor, as has been the case for most of the time after the Second World War.

In short, what is happening in the western world is that we have enormous downward pressure on wages. This is the main reason why we fail to beat the economic downturn. We will not get out of stagnation or recession as long as our economies are being depressed by low wages and corresponding insufficient demand. This had not been understood. Ask western policy-makers for their opinion on what happened and they will tell stories about structural problems. What then is the structural problem in the Western world? Is it too high wages? No. Wages are not too high, they are too low. One is free to call this a structural problem. I do not like the term, because nobody knows exactly what a structural problem is. Regardless, economic policy is based on the same fallacious ideology everywhere. Wages need to be cut and labour markets need to be made flexible. But this does not work.

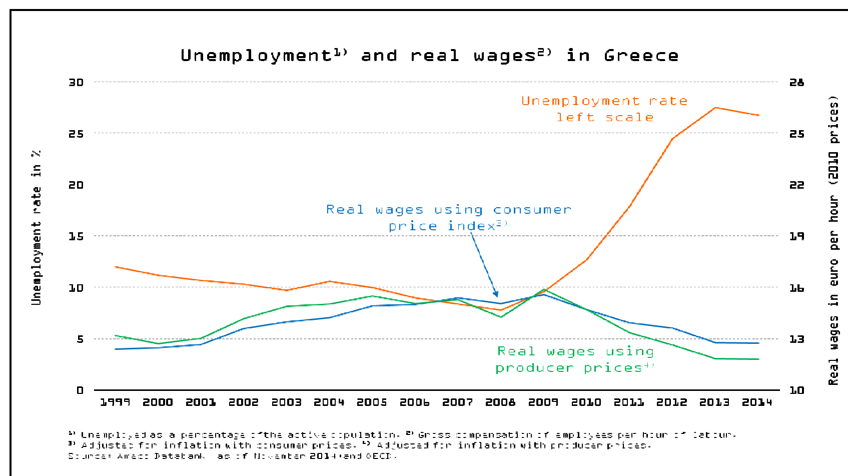
The reason why Europe is doing much worse than the United States is that Europe has put much more pressure on wages than the United States. European policies have gone further than just mere punishment. European policy-makers strongly believe in austerity, although its case has been

crumbling for many years. Although everyone can clearly see that it is in fact counterproductive, they made Greece implement the most austere policies of any European country ever. Look what happened. Greek society is falling apart. Its economy has been decimated.

Before I go further, I need to emphasise the need for developing countries to have reliable data. It is impossible to steer an economy without data. Unfortunately, in many cases reliable date are no available. This is one of the major problems.

Let us have a look at the Greek situation. In the figure, the right hand scale shows the absolute real wage per hour. As one can see, real wages have been falling since 2010 under the pressure of the Troika, which includes the IMF, the European Commission and the European Central Bank. The Troika's policies cut wages in absolute terms by 25 to 30%.

Chart 5: Unemployment and wages in Greece



What has been the effect on these policies on unemployment at the left hand side of the figure? Unemployment rose spectacularly. This completely disproves the case that the IMF and other institutions have been making since 2010. They all strongly believed that the correct way for Greece to return to growth was to cut wages. Make labour cheaper and unemployment will fall, as neoclassical labour market theory has it. In reality, real wages fell by 25 to 30% and unemployment rose. The reason is easy to understand. If wages are cut by 20%, soon enough expenditure and consumption will also fall by 20%. This happens everywhere, any time. Companies now have lower wage costs, but they se themselves confronted with shrinking demand. No company will ever increase production in such a situation, so the best that can be hoped for is that employment remains stable. But this does not happen. As the utilisation of the production capacity of businesses sink, unemployment starts rising accordingly. This very simple mechanism explains exactly what happened in Greece. The neoclassical nexus – cut wages to improve employment –is fallacious.

Neoclassical theory – which my colleague elaborated upon without presenting proof for it – clearly says that lower labour costs unidirectionally lead to higher employment. In this view, the problem is all due to too high wages. When that happens, the demand problem no longer exists. This is fundamentally incorrect. No employer in the world is going to increase employment if wages fall but demand is also falling.

This is what happened in Greece and in other countries of Southern Europe. Wage cuts were nowhere as severe as in Greece, but the empirical evidence for Southern Europe, including Italy, shows the same pattern. Wage cuts and increased labour market flexibility destroyed domestic demand everywhere.

The problem with competitiveness

Is it not correct to say that cutting wages increases competitiveness? Let us deal with the famous concept of competitiveness. Every mainstream economist worldwide agrees that wage cuts increase a country's competitiveness. This is so axiomatic that it is textbook stuff. And it is correct – under certain conditions. How will an increase in competitiveness help a country in which the domestic market has the lion share of GDP and export only plays a subordinate role? In such case, cutting wages will not help, even if they somewhat increase the country's penetration of external markets. This is not a theoretical possibility. It is exactly what happened in Greece, Portugal and Spain. There is indeed a counter example. Ireland cut wages and overall they have been quite successful. This makes perfect sense. Ireland has an export share of 105% of GDP. This means that the Irish economy exports and imports more than Irish GDP. The Irish case does not provide an argument for austerity for which it has become the ideological poster child. Its export share finds no equal anywhere in the EU. Hence, its policies cannot be generalised. It worked for Ireland. It will not work anywhere else.

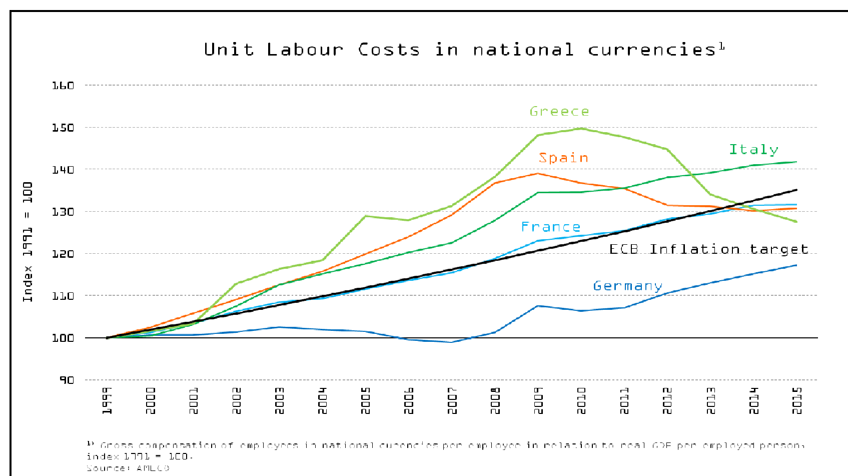
Currency depreciations

The crucial message is that cutting wages do not lead to economic recovery. It makes things worse, not better. There is, however, another possibility that my colleague has also mentioned: instead of cutting wages, it is possible for countries to depreciate their currencies. The result of a currency depreciation is similar to cutting wages, but without having the same negative effects on domestic demand. Countries can, to a certain extent, use depreciations as an instrument to increase employment. There is, however, one unsolvable problem. Any depreciation implies the appreciation of the currencies of other countries. It is not possible for everyone to depreciate, because logically, any depreciation leads to an appreciation of the currencies of others.

Currency depreciation is not a simple matter. It is not simple in a region such as Northern Africa either. Depreciations are certainly ways to increase employment, but there are risks and it cannot be denied that the measure falls under the heading of 'beggar thy neighbour' economics. Countries do of course beggar their neighbours in order to raise employment, but it is easy to see that currency depreciation cannot be a general or a sustainable solution, either for the developing or for the developed world. In fact, depreciation only works – for some limited amount of time – if only one country does it and gets away with it. This is what happened in Europe. Germany *de facto* depreciated and all other countries suffer because of it.

The simple reason for Germany's economic success liesin the evolution of unit labour cost in Europe since the beginning of the monetary union. At the start of the EMU, countries agreed to let wages rise in accordance with increases in productivity and see to it that wages increases should meet the inflation target of 2%. The only country which increased its unit labour costs correctly in order to reach the inflation target has been France.

Chart 5: Unit labour costs and the inflation target of EMU



The dominant interpretation is that all countries have been living far beyond their means: they increased wages by more than the rise of productivity permitted. There is, in some specific cases, some truth to this, but it is not very important and it certainly does not explain the derailment of the European economy. One country's wages were clearly too low – they remained far below the rise of productivity. This is reason for Germany's success. What have the consequences been? It is impossible for Germany's success story to last much longer because all of Germany's trading partnersnow find themselves confronted with problems which they cannot solve on their own. However, the German government provided the European partners with a solution: do like us and become good at beggar thy neighbours. This is, in one word, the basic policy of all economic governance in the EU that Germany dominates not only economically but also politically. And so we end up where were started: the neoclassical therapy of slashing wages and increase labour market flexibility. These policies have turned out to be complete failure, for the reasons that I explained. We remain saddled with persistent high unemployment. Demand has plummeted and so has investment. Another net result has been the occurrence of deflation.

The only policy measure that will let Europe escape from diminutive development and general dysfunction lies in a substantial increase of German wages. Politically speaking, this is out of the question. Germany remains the true believer of cutting wages and it continues to present mercantilism as a solution for Europe's illnesses. It will not last. If Germany refuses to change its policies the euro-zone will, one day, either explode or implode. The problem that the euro zone faces today is the same as the transfer problem that was addressed by John Maynard after the end of the First World War. Just as then, the European problem can only be solved if the creditor cooperates. There can be no solution if the creditor refuses the debtor to adjust, so that all can return to growth. Without a policy change, the euro zone is doomed.

Conclusions

It is all not that difficult to understand. Public debt is part and parcel of the overall savings-investment matrix of an economy. It has to be interpreted in the wider realistic context of the financial situation of other countries as well as in the context of the financial situation of the domestic sectors. Cutting public expenditure with the purpose of cleaning up public budget deficits is only possible if someone else is willing to increase its deficits. Cutting public expenditure because the IMF tells you so will never work. The general conclusion of all these considerations is simple: no positive change can be achieved within the framework of neoclassical and neoliberal ideology. The dogma that has been imposed upon developing countries has prevented a necessary change towards a new system in which the participation of the population at large is a crucial condition for long lasting success.

The neoclassical dogma is wrong. Today, monetarism only exists in textbooks on the history of failures in economics and in science fiction. Growth always needs the stimulus of demand. Such stimulus may come from other countries, as in the German case. If such other countries do not exist, for whatever reason, such as insufficient competitiveness, the stimulus has to come from within the country itself. This means rising incomes for people and the willingness of government to accept higher deficits.

Labour markets cannot and should not be 'flexible' in the neoclassical sense of the word. Flexible labour markets are a dangerous concept: cut wages and make labour markets flexible are excellent ways to destroy consumption and demand. No growth, let alone sustainable development and prosperity can be based on increasing the flexibility of labour markets. No sustainable growth is possible if the population does not have the means to consume what they produce. If they do not have such means, the economy is not growing, it is sinking. Equally essential, the ideology about the 'correct' debt to GDP ratio has to be abandoned. There is no scientific basis to any such figures. Public debt cannot be seen in isolation from other macroeconomic factors such as the trade balance and the balances of the economic sectors – are households saving or consuming, are companies saving or investing? This has to be figured out to start with. Only then it is possible to make intelligent decisions that favour the common good.

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