The Elephant in the Room 23/7/2012

The economic indicators are extremely worrying. Just this past ten days the following details were featured in our newspapers.
- The return on Spanish 10-year bonds jumped above the 7% danger level, more than 600 points above the rates for German 10 year bonds. The Spanish government has cut growth forecasts for 2013 from 0.2% growth to a contraction of 0.5% for 2013. Unemployment is more than 24%! Starbiz 23/7/2012
- Moody's Investors Service cut Italy's bond rating 2 levels to Baa2 and said that further downgrading was possible. Italian 10 year bonds'yield have risen to 6.03% (compared to German 10 year bond yields of 1.2% per year). Italy the Eurozone's third largest economy is Europe's largest bond market with 1.64 trillion Euros of bonds outstanding. Star 14/7/2012

The following points are from Mr Martin Khor's article in Star 23/7/2012:
- In China, GDP growth fell to 7.6% in the second quarter of 2012, a significant deceleration from 10.4% in 2010.
- The IMF has lowered its growth projection for India to 6.1% this year. It was 8.4% in 2010.
- For Brazil, the government has lowered its growth projection for 2012 to 3% (4.5% earlier), but the IMF's projection is even lower –2.5%.
- The Singapore economy contracted 1.1% in the second quarter of 2012 at an annualized rate.

It is clear that the world economic system is in a tailspin, and what is even more worrying is that the people in charge – the leaders of the advanced nations and the head s of the IMF and the World Bank - do not seem to know what to do about it. Some, notably the German Chancellor are insisting on measures to balance national budgets as preconditions for further loans to countries facing difficulties raising money from the bond markets. Their insistence on balancing the budget has pressured governments to drastically cut social security and other government spending leading to a deepening of the downturn and a massive increase in unemployment which is about 50% for the under 30 year olds in several EU countries! These measures have sparked off wide spread protests which have led to changes in government, as well as to an upswing of support for far-right xenophobic parties with fascist tendencies!

Other leaders, including the newly elected Socialist President of France are lobbying for growth stimulating policies. But how does one get growth when aggregate demand is contracting and unemployment is rising. How are citizens going to buy more at this time (and thus stimulate growth)? Sovereign debt has reached huge proportions, and most European governments are finding it increasingly difficult to borrow and spend as part of a Keynesian counter-cyclic measure to boost aggregate demand.

What both these groups are ignoring is the elephant in the room! But before we zoom in on the elephant and discuss what we should do with it, lets take a closer look at the three main features that characterize the current economic crisis –weak aggregate demand, escalating sovereign debt and casino-style financialization of the global economy.

Why is aggregate demand weak?
Aggregate demand is crucial for the growth of an economy. Businessmen produce goods and services because they expect that they can sell the same at a profit. If they feel they will not be able to sell all that they produce, they will scale down their production. According to a book entitled *The Cost of Inequality*, by Stewart Lansley, the share of national output going to wages peaked at 64.5% in the advanced countries in the mid 1970s. By 2008, wages only accounted for 53% of national output. In the meantime the share of national income accruing to the richest 1% increased exponentially. In the US the share of national income going to the richest 1% increased from 8.9% in 1976 to 23.5% in 2007.

Growth of aggregate demand has been sluggish in the advanced countries because of multiple factors including the exodus of manufacturing jobs to countries with much lower wage rates. Outsourcing of services to low wage regions is another part of the same trend. The reduction in the real wage, the contractualisation of labour and the use of migrant labour to further depress wages all add to the list of "labour-flexibility" management techniques that increase the profits of the corporations implementing these measures in the short term but lead to the erosion of buying power on the part of the ordinary citizens, and an aggravation of the problem of under-consumption in the medium term.

The sovereign debt crisis
Almost all countries have been using Keynesian measures to manage their economy – that is they spend to prop up aggregate demand at times of downturns to "pump-prime"the economy. Keynes advocated cutting back on state expenditure and running surplus budgets in times of economic expansion, effectively saving up for the next downturn. Unfortunately, the surplus years have been very much fewer than the deficit years, because of the frequent necessity of government intervention to prop up demand or to save big financial institutions whose collapse would have caused economic and thus political mayhem! In other words persistent sluggish aggregate demand is one main cause of the sovereign debt crisis.

The other major cause is that the tax base of governments has shrunk. The exodus of high paying manufacturing jobs means less tax from ordinary workers. The tendency of the big corporations to set up headquarters in tax havens is another major cause of budgetary deficits. The threat of corporate flight has led governments to drastically cut corporate taxes – for if they didn't, the corporations would just relocate. In Malaysia corporate tax has been reduced from 40% in the 1980's to 26% currently. There are people on both sides of the political divide in Malaysia who are pushing for further lowering of corporate taxes (to as low as 19% so as to compete with Singapore!) as they believe that it would make us more attractive to FDI.

Goods and services taxes have replaced corporate tax as the main source of government income in many countries. But in terms of aggregate demand, a GST only transfers from the right pocket to the left – it increases the purchasing power of government at the expense of the purchasing power of the citizens. GST does not add to aggregate demand.

Financialisation
People with excess funds want to find avenues to make their money earn more money. That is the nature of the game! Investing in manufacturing capacity isn't quite viable if aggregate demand is not growing robustly. Ordinary people just do not have enough money to buy all

the goods that the system could produce! So investment in stocks, in currency trading, in commodity futures, in derivatives and the like have become the only available alternatives for people with surplus profits on their hands. Of course they will go to the fund managers who post the best growth rates. This induces risk taking on the part of the fund managers!

The Elephant – the 1% super rich!

The common thread through all these aspects of the current economic crisis is the gross maldistribution of the income of the world. The marginal propensity to consume is much much higher for people in the bottom ½ of the economy than for the top 1%. The top 1% would want to save or invest a much larger portion of any increment in their income, while the poorer ½ would spend almost all of any increase in their income. Transferring a portion of the income of the top 1% to the bottom 50% of society would immediately boost aggregate demand and act as a good shot in the arm for the world economy. If all countries agreed that they would all simultaneously increase their corporate taxes by 5%, that would greatly help in balancing their budgets and improve their ratings in the bonds market. It would have a salutatory effect on aggregate demand as well.

However, these changes are far easier to propose than to carry out. In fact the analysts in the main stream media do not even dare to propose them! The top 1% have the financial and political clout to keep analysts and the main stream media at heel! They will continue to lobby for a reduction in corporate taxes and the right to set up off-shore accounts, engage in transfer pricing and the like to avoid paying taxes. They will enlist intellectuals who will argue that any attempt to share out the wealth of the top 1% is detrimental to democracy and represents a major assault on human rights! And the 1% has the money to do all of this and more!

But the inescapable fact is this – the tendency for the top 1% to acquire a larger and larger share of the global income over the past 30 years is the major cause of the financial crisis that the world is facing today, and if this fact is not recognized and dealt with, the malaise in the global economy is only going to worsen.

How could the global economy be reinvigorated?

The answer is simple, though its execution is going to be resisted by the group with the best access to the pinnacles of political power- the richest 1% ! This is despite the fact that these are the only measures that can save the capitalist system from a chaotic meltdown!

What we need to do is to increase aggregate demand by increasing the share of global income that goes to ordinary consumers and to governments. This necessarily means that the share going to the 1% has to be reduced to an extent through measures such as raising wage-rates, increasing corporate taxes, closing down tax-havens, taxing financial transactions (Tobbins Tax). However all of these go against current economic orthodoxy which remains essentially neo-liberal. The Free Trade Agreements (FTA) for example pull in the opposite direction – they tend to increase the power of the 1% to dictate terms and increase their share of global income. We would need to rewrite these trade agreements in such a way that the bias towards the 1% is corrected.

I didn't say it would be easy did I? For these measures to work we would need an international consensus, for it would be quite disastrous for one country to attempt these changes on its own! There would be capital flight and serious unemployment in that country as the rich and the corporations scurry off to "greener" pastures! It has to be a community of nations that together agree to shift the balance of economic and political power in the direction of the 99% - that together set targets for minimum wages, corporate taxes and taxes on financial transactions.

But we really have no other choice! If we do not act collectively to inject some sanity and sense of fair play into the way we conduct our economic activities, the crisis is only going to deepen – and as in all crises, it will be the poorest and the most marginalised who will bear the brunt! The first step towards making the world economy more stable and sustainable would be to demystify the current economic crisis, call spades by their proper names and not obfuscate the issue with terms like "contagion"which seems to denote a disease process, or "investor confidence" which seems to imply that its all in the mind – that if everyone had confidence, the system would run smoothly forever! We desperately need to initiate a honest and rational debate on the nature of the crisis and the concrete steps required for its resolution. Only then can we achieve the societal consensus that is required to implement the changes that are required!

Key Economic Indicators

Country / Region	**GDP in 2011[1]** (USD Trillion)	**Public Debt[2]** (as % of GDP)	**GDP Growth 2011[2]**
The World	69.66		3.7%
European Union	17.58		1.6%
USA	15.09	62%	1.5%
China	7.30	19%	9.5%
Japan	5.87	198%	- 0.5%
BRIIC countries	14.17		
Malaysia	0.28	~ 50%	5.2%

Sources: 1. IMF figures; 2. CIA World Factbook

Note –

a/ The combined GDP of the EU, the US, Japan and the UK was US 41.96 trillion in 2011, which represented 64.5% of world GDP.

b/ The combined GDP of the BRIIC countries (Brazil, Russia, Indonesia, India and China) was US 14.17 trillion in 2011 contributing 21.1% of global GDP.

c/ The above 2 facts expose the wishful thinking underlying predictions (by Malaysian government economic planners for example) that robust growth in the BRIIC countries is somehow going to save the global system. For apart from their relatively smaller size, a significant stimulus of GDP growth in the BRIIC countries themselves is export led – fuelled by exports to the EU and to the US.