

# LOW WAGES THE ULTIMATE CAUSE OF THE GLOBAL RECESSION

The global recession is a crisis for the neo-liberal paradigm, says the Washington-based economist Thomas I. Palley. It has led to stagnating wages and a growth fuelled by debt and asset price inflation. What we need, says Palley in an interview with *LookingGlass*, are policies that ensure that the mobility of production does not create a race to the bottom.

How deep is the global crisis which manifested itself in 2007–2008, and what will its long-term consequences be? Despite everything, there appears to be a vague expectation that things will gradually return to business – and consumption – as usual. We will of course need to learn from our mistakes and deal with the excesses, but what if this is not enough, and a somewhat changed world awaits us?

It is not difficult in hindsight to point to serious mistakes before and after the crisis. Alan Greenspan, formerly declared the best Fed leader ever, has fallen from grace and is now regarded as a “serial bubbler”. Inadequate regulation, above all of the so-called shadow banking system, has certainly been contributory to the crisis, as have the incentive schemes inviting excessive risk-taking that the finance sector in particular has featured.

However, the focus on regulation and debatable risk-taking tends to cloud the issue of what are the real causes and extent of the crisis, asserts the American economist Thomas I. Palley in *America's Exhausted Paradigm: Macroeconomic Causes of the Financial Crisis and Great Recession* (June, 2009; New American Contract).<sup>1</sup> Palley, known to a wider readership among other things through *Atlantic Monthly* and *The Guardian*, is among the select collection of economists who for some time have been warning that the American economy would implode due to low pay increases and a high level of indebtedness. In *After the Bust. The Outlook for Macroeconomics and Macroeconomic Policy* (2009), Palley goes head to head with mainstream economists.<sup>2</sup> The neo-liberal policies to which they have given legitimacy have favoured only the financial markets

and the uppermost strata. The world of economics is proficient in marginalising dissidents, says Palley. Whoever is of a different opinion is simply “wrong” and not worth bothering about.

In *America's Exhausted Paradigm*, Palley further pursues his argumentation. The basic cause of the global crisis is the paradigm that has governed above all the American economy in the past 25 years, which incorporates the way in which the USA has related to and shaped globalisation. In Greenspan's defence, one should point out that the USA needed its bubbles to maintain growth. Neo-liberal economic policy concentrates income to the top percentiles and diminishes the buying power of large groups. To keep demand high there is a need for debt-taking and bubbles.

The paradigm of what we now call the thirty golden years from the end of the Second World War to the end of the 70s aimed to create a prosperous middle class that with its income could sustain a healthy demand. The economic policy focused on full employment, and productivity and pay rises went side by side, which created a virtuous circle. Higher salaries increased demand, which in turn contributed towards employment, and full employment created incentives for investments for increased productivity.

When President Ronald Reagan came into office, the target of full employment was abandoned, since it was considered to generate inflation.

<sup>1</sup> See New American Contract's website: [http://www.newamerica.net/publications/policy/america\\_s\\_exhausted\\_paradigm\\_macro-economic\\_causes\\_financial\\_crisis\\_and\\_great\\_recession](http://www.newamerica.net/publications/policy/america_s_exhausted_paradigm_macro-economic_causes_financial_crisis_and_great_recession)

<sup>2</sup> See The Levy Economics Institute's website: <http://www.levy.org/vauthdoc.aspx?auth=211>

Productivity continued to increase, but salaries did not increase correspondingly. It was prerequisite to this that the employees' position should become weaker. Trade unions, the guaranteed minimum wage and work protection were attacked, at the same time as globalisation exposed wage-earners to competition from low-income countries and the threat of outsourcing. Instead of relying on pay to generate demand growth, the neo-liberal model was built on debt and asset price inflation. Consumption has been maintained through reduced saving and increased borrowing. Financial booms provide consumers with collateral to support debt-financed spending. Financial innovations and

deregulation have enabled increased leverage and a broader flora of assets that can be collateralized. American household borrowing increased dramatically during the period 1981–2007. (See Table 1.) The neo-liberal model has also led to growing income differentials. Between 1979 and 2006, the income share of the bottom 40 per cent of US households decreased significantly, while the income share of the top 40 per cent increased significantly. (See Table 2.)<sup>3</sup> Cheap imports have to some extent neutralised dissatisfaction among the broad masses.

This paradigm included a relatively cavalier attitude towards trade deficits. They were in fact seen

as semi-virtuous because they helped to check inflation and because they reflected the choices of consumers and business in the marketplace. This era featured a flawed engagement with the global economy, says Palley. Globalisation as it was formed favoured corporations at the same time as it weakened the USA as a nation. It is however reasonable to wonder whether the corporate sector in the long run sawed off the branch it was sitting on. In its cost-cutting efforts it has kept down wages and thereby reduced demand for its own products. It is significant, incidentally, that the consumption boom in China that everyone is waiting for is being hampered by the fact that salaries are too low. There is a perception in the

West that Chinese wage-earners are saving instead of consuming, whereas the fact is, they do not have much money to consume with, as Palley points out in “External Contradictions of the Chinese Development Model: Export-led Growth and the Dangers of Global Economic Contraction”.<sup>4</sup> It is above all companies in China that are saving.<sup>5</sup>

The American economy has been bled in three ways during the prevailing economic regime. Household incomes have been spent on imports, generating revenue outside the USA. Furthermore, outsourcing has led to the relocation and loss of well-paid manufacturing jobs, mostly to

**Table 1. Household Debt/GDP and Non-Financial Corporate Debt/GDP Ratios by Business Cycle Peaks, 1948–2007**

Year	GDP (\$ billions)	Household debt (H) (\$ billions)	H/GDP	Non-financial Corp debt (C) (\$ billions)	C/GDP
1960	526.4	215.6	0.41	201.0	0.38
1969	984.6	442.7	0.45	462.0	0.47
1973	1,382.7	624.9	0.45	729.5	0.53
1981	3,128.4	1,507.2	0.48	1662.0	0.53
1990	5,803.1	3,597.8	0.62	3,753.4	0.65
2001	10,128.0	7682.9	0.76	6,954.0	0.69
2007	13,807.5	13,765.1	1.00	10,593.7	0.77

Source: FRB *Flow of Funds Accounts* and author's calculations. (Reproduced from *America's Exhausted Paradigm*.)

**Table 2. Distribution of Family Income by Household Income Rank 1947–2006**

Year	Bottom 40%	Next 40%	Next 15%	Top 5%
1947	16.9%	40.1%	25.5%	17.5%
1973	17.4	41.5	25.6	15.5
1979	17.0	41.6	26.1	15.3
1989	15.2	40.2	26.7	17.9
2000	14.1	38.1	26.6	21.1
2006	13.5	38.0	27.0	21.5

Source: Lawrence Mishel, Jared Bernstein, and Heidi Shierholz, *The State of Working America 2008/2009* (Ithaca, NY: ILR Press, forthcoming).

(Reproduced from *America's Exhausted Paradigm*.)

3) See also Gary Burtless, “Globalization and the American Income Polarization”, in *Towards an Hourglass Society?*, eds Kay Glans and Johanna Laurin, Glasshouse Forum, 2008.

4) *Journal of Contemporary China*, Vol.15 (46), 2006.

5) See *The Economist*, August 1, 2009, “The spend is high”.

China. Lastly, companies have been encouraged to move investments abroad, which has reduced domestic spending and denied the American economy modern industrial capacity. Instead of striving for a global market in which American companies might sell their products, the economic policy has aimed at a global production zone for companies. They manufactured products overseas that were then imported to the USA. Transnational companies in particular have lobbied for an economic policy that created a strong dollar, since a favourable dollar rate makes it cheaper for them to do business abroad. This has increased the American consumer's capacity to buy imported goods, but has not helped exports. In the last thirty years, the USA has, in the words of historian Charles Maier, been transformed from an "Empire of Production", into an "Empire of Consumption". How long does an "Empire of Consumption" remain an empire?

In Palley's analysis, the present crisis differs in two ways from the previous crises in the USA, for example the dot.com bubble in 2001. When previous bubbles burst, the consequences were not so serious, since their debt footprint was not so deep. This time it is not possible to increase demand –

neither by further reducing saving nor by finding new ways to raise money through loans. Both these strategies have run their course and the US households now need to get their finances in order. However, if they are over-thrifty, it will prolong the crisis, since demand will be stifled. The cause of the crisis is quite simply that the neo-liberal paradigm is obsolescent, says Palley. The focus on regulation leads to the macroeconomic problems being overlooked. If the neo-liberal model loses its opportunities to blow bubbles, it will find it even harder to create demand. It is striking how dependent growth has been on the housing bubble in recent years.

A new paradigm is needed, but all attempts to approach this are dismissed as protectionism, says Palley. The most important thing is to re-establish the relation between pay and productivity, and this is done by strengthening the position of wage-earners. The threefold bloodletting must be stopped, and companies must be made to work for the nation's well-being. As yet, however, there is little to indicate that the Obama administration is prepared for such fundamental change, Palley states. It appears rather that it is trying to create an interest-rate bubble in Treasury bonds.



Dr. Thomas I. Palley is an economist living in Washington DC. He holds a B.A. degree from Oxford University, and a M.A. degree in International Relations and Ph.D. in Economics, both from Yale University.

He has published in numerous academic journals, and written for *The Atlantic Monthly*, *American Prospect* and *Nation* magazines.

Dr. Palley has recently started a project, Economics for Democratic & Open Societies. The goal of the project is to stimulate public discussion about what kinds of economic arrangements and conditions are needed to promote democracy and open society.

Dr. Palley was formerly Chief Economist with the US – China Economic and Security Review Commission. Prior to joining the Commission he was Director of the Open Society Institute's Globalization Reform Project, and before that he was Assistant Director of Public Policy at the AFL-CIO.