5

The Current Financial Crisis: Causes and Policy

Peter Kriesler

The driver of the current crisis is the collapse in domestic aggregate demand, originating from international factors. It is important, therefore, to consider potential areas where aggregate demand can be expected to increase in order to understand the possibility of recovery. The current crisis was preceded by an unprecedented increase in the level of household debt, which will hinder the recovery of consumer expenditure. Consumption is also being affected by uncertainty with respect to both income and employment. Similarly, the outlooks for investment and net exports suggest that they are unlikely to contribute to the initial phase of recovery. This leaves the important area of government expenditure. It is argued that government expenditure, particularly on infrastructure and capital, is particularly important as in the short run it contributes directly to demand, while, in the longer run it boosts growth and productivity. Finally, approaches to financing the implications of increased government expenditure are examined.

5.1 Background

The main impact of the current economic crisis on the Australian economy has been through rising unemployment rates and falling growth rates. There can be little doubt that the driver of the crisis is a collapse of domestic aggregate demand. The impetus for this was initially from international factors, translating into the domestic economic environment. It is important, therefore, to consider the likely scenarios for an increase in aggregate demand in order to understand the possibility of recovery.

As in previous international downturns, the current global financial crisis was preceded by a long period of increasing asset prices, particularly in property and stock markets. These, in turn, played a significant

Revised from *Economic and Labour Relations Review*, 19(2): 17–26, 2009, 'The Current Financial Crisis: Causes and Policy,' by Kriesler, P. With kind permission from SAGE Publications. All rights reserved.

J. Halevi et al., *Post-Keynesian Essays from Down Under Volume II: Essays on Policy and Applied Economics*
© Joseph Halevi, G. C. Harcourt, Peter Kriesler and J. W. Nevile 2016

role in increasing demand from both households and business. Business balance sheets improved as a result of the increased value of their assets. This improved business confidence, encouraging investment. Banks, at the same time, were increasingly happy to lend money for these investments. Simultaneously, since the asset prices affected were both shares and house prices, consumers became wealthier. This increased wealth boosted their confidence, leading to substantial increased expenditure, often financed by debt. One distinguishing feature of the boom which preceded the crisis was that households borrowed record amounts on the basis of their increased asset prices, leading to record levels of household debt, as Figure 5.1 shows.

Financial crises are often precipitated by banks reassessing their liabilities, and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. This leads to re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets, and to significant asset price falls (Minsky 1985).

The current crisis followed the same basic pattern with two important differences. Firstly, as noted above, households, as well as firms, went into significant debt; and secondly, there is the role of so-called 'toxic assets', in particular, those associated with subprime mortgages. In this case, the crisis was triggered by an evaluation that the assets held by many enterprises were, in fact, worth substantially less than their current valuation.

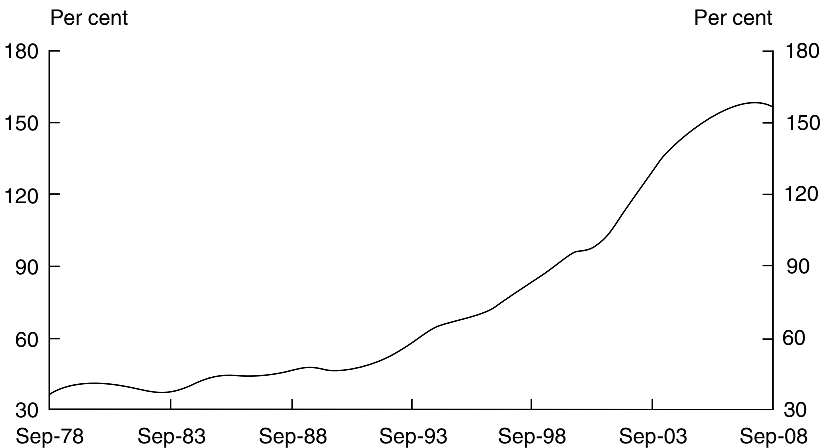

Figure 5.1 Household debt-to-income ratio in Australia
Source: Reproduced with permission of Australian Treasury.

In Australia, the crisis has been associated with a substantial rise in unemployment rates, from 4.2 per cent in April 2008 to 5.7 per cent in May 2009, and substantial falls in GDP as indicated in the Figure 5.2.

Associated with this fall in output growth have been a fall in investment and a substantial slow down in consumption expenditure. Prices similarly have reflected the fall in demand, with the CPI falling in the December 2008 quarter by 0.3 per cent, and rising in the quarter to March 2009 by only 0.1 per cent. The annual rise in the CPI was 2.5 per cent for the year to March 2009, compared to an annual rise of 3.7 per cent to December 2008 (Australian Bureau of Statistics 2009b).

The falling CPI, falling growth rate and increasing rates of unemployment indicate that the underlying cause of the current situation is a substantial fall in aggregate demand. Any recovery program would, therefore, need to stimulate some of the components of aggregate demand.

The next section will outline the major components of aggregate demand, and consider what has happened to each of them during the crisis. It also considers which of these is most likely to be able to generate the increased demand needed to move the economy out of the downturn. Investment, in

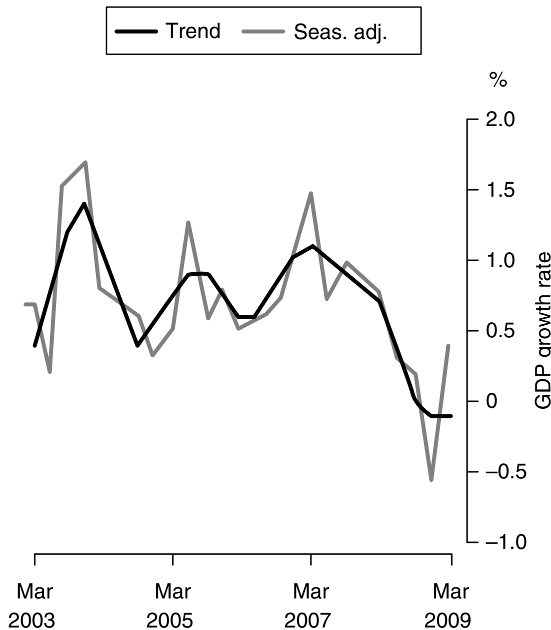

Figure 5.2 GDP growth rates: Australia (volume measures, quarterly change)
Source: Australian Bureau of Statistics 2009a.

particular, has a key role, as in the short run it stimulates demand while in the long run it sustains growth and boosts productivity.

5.2 Aggregate Demand

Total demand in the economy comes from four main sources:

- Consumption demand
- Investment demand
- Net exports and
- Government demand.

So, we need to consider why these have fallen, and what policies can be enacted to reverse that decline. In order to understand this, the global and domestic economic environment are important considerations. Here, the most salient features are the global contraction of economic activity, the underlying problems with financial institutions, and the general high level of uncertainty.

5.2.1 Consumption

With consumption, there are a number of forces operating, not all in the same direction. One important factor to consider is that, as discussed above, coming into the present crisis, household debt in Australia was at a record level as a proportion of household income. In other words, households had borrowed, mainly to pay for houses, but also for other large items. Coming into the downturn, the Reserve Bank had been increasing interest rates for some time. This meant that households' real disposable income after debt repayment had been falling. This was reinforced by large increases in petrol prices, which are a vital part of household expenditure, and left less income for other expenditures.

Some of this debt was the result of asset bubbles, though most of the evidence suggests that this is a lot less of a problem in Australia than elsewhere.[1] In particular, there was a prolonged period of increase in housing prices, which provided the security for households to borrow against.

The recent reductions in interest rates have had a positive effect on households, increasing their disposable income as their debt repayment fell. However, given existing levels of debt coupled with the increased uncertainty and general lack of confidence, it is no surprise that households have been reducing consumption, being more worried about repaying debt, and saving for future eventualities than using any increased income to finance consumption. This has been reinforced by the growing levels of unemployment, which leads to job as well as income insecurity.

As a result, the ratio of consumption to GDP has been falling, perhaps temporarily offset by some of Prime Minister Rudd's cash handout, but we can expect it to continue to fall, and certainly not be a major contributor

to the early phase of any recovery. In fact, consumption in the consumption ratio is unlikely to rise until both employment and output recover significantly, so that consumers have both the means and the confidence to increase their expenditures:

> The large falls in household wealth stemming from the collapse in global stock markets, combined with concern about rising unemployment, are expected to continue to weigh heavily on household confidence and consumption. Helping to moderate these negative effects is substantial assistance to the household sector from government stimulus packages, cuts to interest rates, and falls in oil prices. While this assistance has helped support economic activity, it cannot fully offset the negative effects of the global recession (Commonwealth Government 2009).

5.2.2 Investment

Investment, despite low interest rates, is falling, and is expected to fall by 18.5 per cent this financial year (Commonwealth Government 2009). Investment is mainly about building capacity, and given falling levels of demand, both domestically and globally, it is no surprise that there is little incentive to invest. This is reinforced by the nature of the current crisis, in particular the collapse of confidence in the financial sector. Even if business was prepared to borrow to finance investment, there is a great reluctance by financial institutions to lend, as they do not know which firms may have problematic assets in their portfolios, so that who are safe and reliable borrowers is no longer clear. This represents a double squeeze on investment, as both the motive to invest and the potential to finance any desired investment are being simultaneously squeezed. Investment activity is undertaken when it is profitable to do so. Interest rates enter into the calculation as part of the cost of financing investment. This means that unless there is an expected revenue gain from a new investment project, it does not matter how low interest rates are, investment will not respond. In other words, we would expect investment to be interest inelastic in a downturn as then business does not expect to be able to sell the output of any investment project. If a company does not expect to generate any increased sales from a new project, then even if the interest rate is zero, it is unlikely to invest in that project. When the economy picks up, as it moves into boom, sales and expected revenue, the perceived profitability of investment, will improve.[2] This explains why, despite the current record low interest rates, investment is not expected to recover.

We know that Australia has traditionally relied on global capital to finance domestic investment, increasingly so in recent years. However, in the current situation, this source of funding is drying up with the general reluctance of financial institutions to lend.

Again, it would appear that investment will not be a major contributor to the early phase of a recovery, as investors will have neither the will nor the means.

5.2.3 International Demand

For Australia, reliance on international trade as a major source of demand has been increasing substantially since the opening of the economy initiated by the Hawke government. As a result, the importance of net exports to the domestic economy has grown enormously. We know that much of the strong economic growth for the last decade was due to the global resources boom, which has now been very much reversed and is a major cause of our problems. In fact, the role of international factors in Australia's current downturn cannot be stressed enough. Although international factors could help Australia recover, given the current international environment, to say that this is unlikely is an obvious understatement. The prognosis for a recovery of global demand is not good. Europe and North America are experiencing negative growth, and the expectation is for little change. Although China—currently Australia's main trading partner—is still growing, its growth rate has fallen substantially, and again is unlikely to recover for a while.

This suggests that waiting for the international economy to recover is likely to take a long time.

5.2.4 Government Demand

This leaves the role of the government sector. For the last few decades, economists in academia, business and policy advising positions have been pushing a neoliberal agenda, with an underlying ideology that sees markets as being efficient at delivering optimal outcomes, and governments as being impediments. From the 1970s, neoclassical economics reasserted its view of the superiority of markets, and has dominated economic policy with an emphasis on smaller government and lower taxes. Since that time, as a result of that rhetoric, governments have been reducing their contribution to demand in the economy by decreasing both their spending and their investment. Budget surpluses and shrinking public sectors have been seen as good things in their own right (Bell 1997). The current global financial crisis is partially the result of that policy regime.

However, following the important work of Keynes and Kalecki, we know that capitalist economies only generate enough demand to fully employ the labour force by fluke. There is no mechanism within the economy that pushes it to full employment. This means that there is, and always has been, an important role for governments to supply aggregate demand to the economy in order to ensure that the labour force is fully employed.

5.3 Policy Options

This leads to the question of what policies the government should utilise in the current situation.

1. Not monetary policy. Globalisation has also eroded the effectiveness of monetary policy (Kriesler and Nevile 2003). Also, it is generally accepted

that monetary policy is a blunt and uncertain instrument. Not only is monetary policy associated with long and variable lags, but there is significant uncertainty as to the size of its impact.[3] In particular, monetary policy mainly operates through the impact of interest rates, and as has been argued above, these are not very effective in economic downturns.

2. The government can increase domestic demand via tax cuts or one-off payments. Tax cuts and one-off payments, although increasing take home income, may not have the desired effect on domestic employment, either because the extra income is saved or because it is spent on imported items (such as plasma televisions) which do not generate many jobs in Australia. In addition, tax cuts reduce the government's ability to raise revenue in future years. Often tax cuts are heavily skewed towards cuts for high income earners, rather than those who really need them at the bottom end of the income distribution. Higher income earners tend to both save more out of each additional dollar, and have a higher import component.
3. Most importantly, government can increase demand by their expenditure, particularly on infrastructure and government investment in both physical and human (education, health) capital. The importance of expenditure on capital cannot by stressed sufficiently: not only does it directly create jobs by employing people to work on infrastructure programs, or increase employment in education and/or health, but it also has important long-term benefits for the economy in the form of increased productivity. So government expenditure of this type both increases demand and employment in the short run, while increasing productivity and hence competitiveness in the longer run.

5.4 Governments and Deficits

The recommendation of increased government expenditure is often met with the question of how that increased expenditure will be financed.

The first point to note is that governments are not like households in many important aspects relating to their budgets and expenditures. Households, in order to increase their spending, need to reduce their saving rate, run down their previous savings or borrow. In other words, their expenditure needs to be financed: the money needs to come from somewhere. If the financing is from a loan, then this leads banks to create deposits in the borrowers' accounts, which they can then use to pay for their expenditure. The deposit is created electronically, and the payment may also be electronic. So, money is created, but not in the sense of an increase in notes and coins, but rather as electronic ledgers with financial institutions. Modern money is increasingly associated with electronic holdings and transactions without any necessary change in what the public associates with money: that is, notes and coins. It is important to realise that when economists talk about changes to the money supply, it is not the actual quantity of notes and coins in

circulation that is being referred to. This is a small part of the whole. By far, the most important part is deposits with banks. Nowadays, these are created and moved electronically, and form the largest part of the money supply. It is now generally agreed that the money supply responds to changes in prices and transactions, rather than vice versa.[4]

The government, unlike households, simply does not 'finance' its expenditure. When it spends more, the Reserve Bank creates a deposit on an electronic ledger, which the government then 'spends'. It is this spending which increases the money supply, and is referred to as printing money, if not balanced by borrowing from the public (Bell 2000). In current circumstances, any deficit should be financed by a loan from the Reserve Bank, not by borrowing from the public at all.

There is never a need to 'finance' a government deficit (Bell 2000; Hart 2009). Rather, the government may increase taxes—which reduces the deficit—or borrow from the public to reduce the impact on demand of the increased spending, particularly if it is worried about inflation. Inflation is not currently a problem. A loan from the Reserve Bank need never be repaid. Whether or not it should be depends on the economic circumstances of the time. Often it should never be repaid, though in some circumstances there may be political advantages in doing so (Nevile 2009).

If a country's public debt is held by its own citizens, the liability (to taxpayers) is balanced by the assets of those citizens who hold the debt. Nevertheless, the consequences for income distribution of a continually growing public debt may be important. In theory, these could be overcome through taxation and other fiscal measures for redistribution, but if the interest bill is large, this may not be feasible for political reasons. Even so, the widely cited rule that the budget should be balanced, not over a year but over the business cycle, is too strict as it ignores the effects of inflation and economic growth. If nominal gross domestic product is growing, there can be a positive budget deficit on average over the business cycle without any upward trend in the ratio of public debt to gross domestic product. However, in the case of Australia this discussion is purely academic since our public debt—net of debt between different levels of government—is close to zero.

5.5 Conclusion

This article has argued that the main consequence of the global financial crisis has been a significant collapse of demand in the Australian economy. In particular, all of the components of private demand, consumption expenditure, investment and net exports have fallen. None of these are likely to recover in the foreseeable future. As a result, the only way of preventing slow growth in output, and further increases in the unemployment rate, is for government expenditure to take up the 'slack'. In particular, government expenditure on infrastructure and capital serves the function of increasing

demand in the short run, while increasing productivity and growth in the longer term. Finally, the objection to this policy that the increased expenditure must be 'financed' was examined and, it was argued, was not a substantial problem, particularly in the current circumstances.

The importance of the role of public investment and spending in generating employment and growth are a central theme of this article. It is argued that in the current economic downturn, unless they take a central role, unemployment is likely to rise substantially.

Acknowledgements

I wish to thank, but not implicate, two anonymous referees for their helpful comments.

Notes

1. See Stapledon (2009).
2. This story is reinforced by the empirical evidence on the interest elasticity of investment which suggests little, if any, responsiveness (see, for example, Milbourne 1990: 246–248; Eisner 1991; and Bernstein and Heilbroner 1991).
3. See Kriesler and Nevile (2003).
4. See Hart (2009).

References

Australian Bureau of Statistics (2009a) *Australian National Accounts: National Income, Expenditure and Product*, March 2009, ABS Cat. No. 5206.0, available: http://www.abs.gov.au/ausstats/abs@.nsf/mf/5206.0/ [accessed 19 May 2009].

Australian Bureau of Statistics (2009b) *Consumer Price Index, March 2009*, ABS Cat. No. 6401.0, available: http://www.abs.gov.au/AUSSTATS/abs@.nsf/ProductsbyCatalogue/938DA570A34A8EDACA2568A900139350?OpenDocument [accessed 19 May 2009].

Bell, S. (1997*) Ungoverning the Economy*, Oxford University Press, Melbourne.

Bell, S. (2000) 'Do taxes and bonds finance government spending?', *Journal of Economic Issues,* Vol. 34 (3), pp. 603–620.

Bernstein, P. and Heilbroner, R. (1991) 'The relationship between the budget deficits and the saving/investment imbalance in the U.S.: Facts, fancies and prescriptions', in J. Rock (ed.) *Debt and the Twin Deficits Debate*, Bristlecone Books, Mountain View, pp. 109–132.

Commonwealth Government (2009) *Budget Paper No. 1 Statement 2: Economic Outlook*, available: http://www.aph.gov.au/budget/2009-10/content/bp1/html/bp1_bst2-01.htm [accessed 19 June 2009].

Eisner, R. (1991) 'The deficits and us and our grandchildren,' in J. Rock (ed.) *Debt and the Twin Deficits Debate*, Bristlecone Books, Mountain View, pp. 81–107.

Hart, N. (2009) 'Discretionary fiscal policy and budget deficits: An "orthodox" critique of current policy debate', *Economic and Labour Relations Review*, 19 (2), pp. 39–58.

Nevile, J. and Kriesler, P. (2003) 'Macroeconomic impacts of globalization', in H. Bloch (ed.) *Growth and Development in the Global Economy*, Edward Elgar, Cheltenham, pp. 173–189.

Milbourne, R. (1990) 'Money and finance' in S. Grenville (ed.) *The Australian Macro-Economy in the 1980s*, Reserve Bank of Australia, Sydney, pp. 222–276.

Minsky, H. (1985) 'The financial instability hypothesis: A restatement', in P. Arestis and T. Skouras (eds) *Post-Keynesian Economic Theory*. Wheatsheaf, Brighton, pp. 24–56.

Nevile, J. (2009) 'The Current Crisis Has a Silver Lining', *Economic and Labour Relations Review*, 19 (2), pp. 27–38.

Stapledon, N. (2009) 'Housing and the Global Financial Crisis: US versus Australia', *Economic and Labour Relations Review*, 19 (2), pp. 1–16.

Thorne, S. and Cropp, J. (2008) 'Household saving in Australia', Australian Government, The Treasury, Economic Roundup Issue 4, available: http://www.treasury.gov.au/documents/1451/HTML/docshell.asp?URL=06%20Household%20saving%20in%20Australia.htm [accessed 9 May 2009].