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Changing Income Structure and Financial Crisis

Abstract

Goal of the paper is to show that the major tendencies one can observe recently in the income structure, should be considered as a major root of crisis which begun in 2007. Declining wages share in the GDP and rising income inequalities in both developed and developing countries, led to development of two major causes: global imbalance and unsustainable level of household debt. There are also serious worries that counter-crisis economic policy is not aimed to solve structural problems and in the long term it can make situation even worse.

Introduction

A lot has already been written about the crisis which is considered to have started by the bankruptcy of the Lehmann Brothers investment bank in September 2008[1]. Today, probably nobody has any doubts about the fact that it is not one of the many crises that occurred towards the end of the 20th century - this time, we are dealing with problems comparable to the Great Depression in the years 1929-33. The depth of the crisis (measured by a decrease in economic activity) and its extensity, i.e. the share of the global economy it has affected, requires searching for basic and fundamental causes of this collapse, as it can be seen that the scale of crisis-related processes cannot be accounted for by means of its direct cause, i.e. the slump in the market of financial instruments based on the so-called *subprime* loans.

As times go by, more and more publications indicate deeper roots of the crisis and more and more often attention is focused on the income inequalities which led to the macroeconomic imbalances (Rajan 2010, Stiglitz 2012).

This text is aimed at indicating that the tendencies observed in the income structures of the most important world economies significantly contributed to the accumulation of processes which finally led to a slump in financial markets, leading to a collapse in the area of real economy.

The study is organized in the following way - the first part presents two most important consequences of the present stage of globalization for the dynamics and structure of the income. Next, the relationship is shown between the division of income in the economy and processes which led to the outbreak of the crisis. In the last part, it is shown that the anti-crisis policy of many countries did protect the global economy against deep recession, but its long-term results can have a negative effect on social cohesion and, thus, may constitute a source of future problems.

Globalization and incomes

Globalization, which is understood as a process of integration of national and regional markets of goods, service, capital and workforce into one global economic organism, must affect the division of income both between individual countries (regions) and the structure of income within national economies.

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[1] Among many publications it is worth to mention: Roubini, Mihn 2010, Stiglitz 2009,Reinhart Rogoff 2009 or entire volume of Journal Economic Perspectives Vol. 24, No. 4, Fall 2010

The set of economic processes which are jointly called globalization affect the dynamics and structure of income in individual national economies via a whole range of impact channels. We are interested in economic processes which involve:

- the changing demographic situation;
- the growing flow of goods and services on a global scale;
- capital flows increasing at a very fast rate, the growing role of the financial sector;
- the dissemination of the division of the production process by means of outsourcing and offshoring.

Over the past 20 years, the size of workforce in the world grew four times[2]. However, this extremely dynamic growth has been very unevenly distributed on a global scale - significantly higher dynamics of working people can be seen in developing countries than in rich economies, such as the USA and Western Europe. This status quo is primarily caused by demographic factors in developing countries. Progress in the access to medical care in poor countries and obviating famine in most parts of the world where simultaneously a high birth rate is maintained had to lead to a fundamental change in the demographic structure in developing countries. Previously, in view of the high child mortality, the increase in the number of people at the working age was relatively low, and now a considerable number of people read to undertake employment appear. Interestingly, despite the obvious progress in the opening of job markets in OECD countries, the share of immigrants in the workforce in rich economies remains largely unchanged - it has been at the level of approx. 15% in the USA and 10% in the European Union for over a decade. It is obvious that the increase in the number of workers is characteristic of developing countries, which, taking into account the relatively low migration rates, does not have a considerable influence on the demographic situation in highly developed countries. The structure of the increase in the workforce is also interesting from the point of view of its education - the number of working people with higher education has increased only by 50% over the past two decades, the rest of the increase (350%) in the numbers of people ready to work are persons with lower qualifications. There is no doubt that the considerable increase in the workforce numbers in poorer countries had to translate into the situation on the job market in these countries; however, this situation also affects job markets in OECD countries. Although the role of immigrants in the generation of the GDP in G7 countries increased in the years 1990-2005 only by approx. 1 percentage point (from 6 to approx. 7%), the imports in these economies increased at the same time by as much as 1/3 - from 30 to 40% of the GDP. Obviously, it must be reflected in the exports of the developing countries, which grew very dynamically from approx. 25% of the GDP in the year 1990 to almost 45% in the year 2005. Even if the increase in the exchange within the group of developing economies is responsible for part of the increase in the export share in the GDP, it does not change the thesis about the fundamental tendency in the global foreign trade - highly developed countries are becoming importers to a larger extent and the economic dynamics in developing countries is more and more dependent on the exports. What is equally important, the structure of exports from developing countries to affluent countries - over a half of the first decade of the 21st century, industrial products made up as much as 30% of the exports with the diminishing role of agricultural produce and natural resources. Obviously, it is China that is mostly responsible for this status quo - its share in the export of industrial goods to OECD countries increased from 2% in 1990 to nearly 10% 15 years later.

Another channel of impact between rich countries and developing economies is the growing scale of capital flows, both in the form of direct foreign investments and indirect investments. In the year 1989, over 21 billion dollars' worth of direct investments were located in emerging and developing economies and in 2008, this amount grew to 439 billion

[2] Source of the data in this section is IMF World Economic Outlook Database

dollars. Data concerning portfolio investments are even more interesting - developing countries, mostly due to China, and some oil-producing countries become capital exporters mostly to the USA, which appear to contradict the theory claiming that the capital should move in the direction from richer to poorer countries, where it is possible to achieve a higher rate of return.

The outsourcing and offshoring of further production stages from highly developed countries is another interesting process, which has been on the rise in recent years. Owing to the development of telecommunications technologies, it is even possible to provide services, such as tuition or telemarketing from the other end of the world (Friedman 2007). Despite the fact that the role of outsourcing is not big yet (approx. 5% of the GDP in OECD countries - IMF data), but it has been increasing on a continuous basis and, the important fact is that production with a higher value added is “moved" out of affluent countries [IMF, 2005, p. 166]. This status quo is understandable - it is easier to import products and services which do not require the use of high technology from developing countries, instead of establishing foreign branches of companies.

It is also worth to mention another links between globalization and income structure in developed economies. For example Haskel, Lawrence, Leamer, Slaughter (2012) find that foreign trade has quite limited role in explaining growing income inequalities in the US and more important are soaring incomes of superstars (actors, sportsmen, top managers etc.) who are able to exploit globalization of culture or entertainment.

Houseman, Kurz, Lengermann, and Mandel (2011) indicate that outsourcing and offshoring not only depress wages in manufacturing in the US but also contributes to the high productivity growth in the sector (only high value added production “stay” in the US what is clearly seen for example in electronics which based very much on the production of Asian factories). As a result, salaries are lagging behind productivity, so managers and owners of the capital are able to get bigger share of produced income.

Income structure and growing crisis

The tendencies presented above, i.e.:

- a considerable increase in workforce (primarily in developing countries), mostly with low qualifications;
- a dynamic growth in foreign trade and its structure changing towards the growing share of industrial goods manufactured in developing countries,
- transferring production from highly developed countries to developing countries, mostly by means of direct foreign investments, but also by means of outsourcing, must have far-reaching consequences for the income structure both in poor and rich economies.

The pressure on the part of goods imported from low-cost countries and the possibility of transferring production abroad has led to a fundamental decrease in the bargaining power of employees in OECD countries. The United States is a good example here - there has been practically no increase in the real wages of employees in this country (in the years 1990-2008, the real wages in the USA grew only by 3.3% - OECD data), despite a fundamental increase in work efficiency. This status quo had to lead to a radical decrease in the pay share in the GDP, which has taken place not only in the USA, but also in other highly developed economies. In 1993, the wages compared to the GDP amounted to 64, 65, 79 and 58% in the USA, Great Britain, Germany and Holland respectively, while in 1993, this index decreased to 54, 57, 67 and 45% (OECD data). The stagnation of wages results in the growing role of capital income and a relatively new phenomenon in the global economy, i.e. company profits growing at a very fast rate, which are largely not intended for material investments, but are

accumulated (the so-called company savings) and placed in the financial market (IMF 2006). The processes mentioned above had to lead to increasing income inequalities in rich countries - "stagnant" wages mean low company costs; therefore, profits, which are the basis of high remuneration for the managing staff, and, at the same time, the capital flowing into financial markets (company profits and capital from countries with a high trade surplus, such as China and oil exporters) raises the prices of financial instruments, which is followed by increasing salaries of financiers, who are remunerated on the basis of short-term results. The growing stratification can be best seen where globalization processes (high turnover in the goods and capital markets, a big role of the financial sector) are the most advanced, i.e. in the USA and Great Britain. In the year 1980, the Gini coefficient amounted to 34.7 in the USA and 25.2 in the UK to rise to 46.4 in the USA and 34 in the UK in the year 2007 (data from the WIDER database).

At the same time, the income stratification in developing countries deepens, which can be surprising, since a relatively poor economy, which is included in the global economy by exporting mostly low-processed goods should rather record a decrease in income inequalities since the demand for low-skilled workers grows. However, the Gini coefficient in China increased from 28 to as much as 47 in the years 1980-2006 (source as above). Nevertheless, it needs to be remembered that China's economic success does not only consist in the dynamically growing exports in which the role of high added value products grows, which requires the employment of managers and specialists with high qualifications. Therefore, since we have access to huge numbers of low-skilled workers and, at the same time, we need a limited number of managing staff, the income inequalities must rise, as it results from the necessity of high salaries paid to specialists and the possibility of maintaining low wages for low-ranking employees.

The intensification of globalization processes led to the stagnation of income of a vast majority of society in both rich and poor countries, which translated into a general increase in income inequalities. It is estimated (Cornia, Court 2001) that from the 1970s to the beginning of the 21st century, the income stratification increased in as much as 71% of the world economy. Can the changing wage structure be associated with the current financial crisis? I think it can.

Firstly, the stagnation of wages in rich countries (primarily in the USA) led to a dramatic increase in the household debt - if the income stays practically at the same level, the use of loans is the only possibility of keeping up a high rate of consumption growth. In the years 2002-2007, i.e. until the outbreak of the crisis, the household debt compared to the income increased from 110% to 138% in the USA; from 134% to 183% in Great Britain from 75 to 100% in France (OECD data). Out of the G7 countries, German households decreased their debt in this period from 111 to 102%. The growing household debt, as opposed to loans for funding company investments, are bound to cause external imbalance - growing consumption funded with loans results in deficiencies in national savings, which is demonstrated as a current account deficit. This process is clearly visible in the USA - in the years 2006-07, the current account deficit reached as much as 6% of the GDP.

The dynamically increasing economic debt translates into intensive changes in the financial sector. On the one hand, the securitization process (sales of loans granted), which allows for conducting loan actions without raising the capital. On the other hand, further innovative financial instruments, the so-called Mortgage Backed Securities (MBS), aimed at enabling the achievement of high rates of return resulting from a rapid increase in real property prices.

Secondly, the deep income imbalance in developing countries (primarily in China) makes it possible to keep a high level of savings in the economy. At its low level, only unevenly

divided income may result in high savings, which results from the end tendency to consume which decreases with a rise in the income. A very low consumption level in China makes it possible to keep a high investment rate (the accumulation rate reaches up to 50% of the GDP), which is accompanied by rapid GDP growth, but, on the other hand, manufactured goods must be exported as there is not enough consumption demand in the domestic market. China's high exports simultaneously mean high imports in the United States, and thus, the phenomenon called global imbalance arises.

Thirdly, high imports from low-cost countries to highly developed economies lowers the inflation pressure[3] in the latter, which induces the central bank to keep low interest rates. This seemingly comfortable situation for the central bank creates a favourable environment for the formation of speculative bubbles. Access to cheap money increases the demand for financial assets by means of loans, which could be seen, for instance, in the real property market or the market of financial instruments connected with the mortgage loan market.

Fourthly, considerable demand for loans, both on the side of the private and public sectors, does not translate into growing market interest rates, which would allow for the reduction in the consumption rate, because at the same the capital supply increases as it arrives from countries keeping trade surplus - China, Germany, Japan, Russia and oil exporters. The capital inflow causes low capital acquisition costs and fast-growing prices of financial instruments, for which the demand is constantly high.

The increase in the imbalance inequality scale, both in economies of rich and developing countries, led to an unfavourable shape of the global structure of the income division. It is high savings of highly developed countries should serve the funding of high investment and consumption rates in poorer countries, which would make it possible equalize standards of living. The reverse situation occurs - in highly developed economies, loan-funded consumption grows fast in highly developed economies which have their source in the capital inflowing from the poorer part of the world economy. This situation is responsible for the development of two fundamental reasons for the financial crisis - global imbalance (current account deficit in the USA and surplus in China) and an uncontrollable development of the financial sector.

Does the reaction of countries to the crisis solve its causes?

Observing spectacular anti-crisis movements, both on the part of fiscal and monetary policy, gives the impression that actions taken by governments and central banks are aimed at fighting the effects of the current turbulence and not the removal of its structural causes. In the long run, one can even expect that the unfavourable income structure in the economy may even become further aggravated, i.e. income inequalities will grow.

The governments spared no expense to fund financial institutions which, by their incautious investments, led to the crash of the entire world economy, but households in debt practically did not gain any support, so their position is becoming weakened. It is mentioned by Stiglitz (2009), who indicates that the state's support should reach those who are not capable of handling their payments connected with mortgage loans. Firstly, it is about persons with houses at the so-called negative equity point - the amount of the loan exceeds the value of real property, which makes it completely unsellable, which effectively decreases the mobility of the workforce in the USA. This is confirmed by a relatively high unemployment rate.

A very expansive fiscal policy constituting a reaction to the slump in the private sector (investments and consumption), undoubtedly, made the world recession more shallow and

[3]The inflation pressure is additionally weakened by the cost factor - the possibility of keeping employee wages at a low level.

shorter, but a question arises how fiscal adjustments, which have to be introduced and already are being introduced in some countries, will translate into social cohesion in the economy. Generally, there are no doubts that fiscal adjustment will have pro-recession effects (IMF 2010, Perrotti 2011), so again low-ranking employees will be the most affected - they will lose their jobs as unemployment will be on the rise and those who will keep their jobs will certainly get no pay rise. Looking at the countries which have already reduced their budget deficit (Greece, Spain and the Baltic states), it can be seen that the imbalance in public finance is decreased by cutting down on social transfers and raising indirect taxes, which mostly affects poorer layers of society. The countries' growing dependence on financial markets results in a situation in which actions aimed at distributing the cost of fiscal adjustments in another way, for example, by increasing taxes on capital profits or by introducing some form of the Tobin tax, would not be approved by financial institutions, which would refuse to fund the public debt of such countries, the way it happened in Greece.

Lax monetary policy, together with the famous quantitative easing, will also have its long-term effects for future income. First of all, a large part of liquidity provided to the market by central banks practically does not go beyond the financial sector as the loaning activity has almost disappeared. An increased money supply in the financial system can be observed, despite high changeability in numerous markets - new speculative bubbles emerge in the stock, foreign exchange and raw materials markets. There are two ways out of such an expansive monetary policy: to consent to higher inflation, which is sometimes mentioned (Blanchard et al. 2010) or we can expect an abrupt increase in interest rates and aggressive market sterilization by central banks in the future. Both higher inflation and a rapid increase in interest rates particularly affect the poorer. With a weak position on the job market, we usually have to agree to a reduction of real wages and, additionally, we must remember that households are heavily burdened by debt so that significantly higher interest rates can cause debt management problems.

Conclusions

The large scale of the current crisis makes it necessary to look for its deep structural causes as there are generally no doubts that the slump in the subprime loan market was just a direct trigger which led to the outbreak. The aim of this text was to demonstrate that the changing income structure in the world economy greatly contributed to the development of the crisis. Undoubtedly, further research in this area would be justified in order to identify the causes of growing income inequalities in a more precise manner, for instance, by analyzing the income dynamics in various social and professional groups and, finally, in the regional system of individual countries.

Unfortunately, there is every reason to believe that the fundamental causes of world economy problems have not been removed and the anti-crisis economic policy, despite solving some of the short-term problems, does not allow us to be excessively optimistic about the future.

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