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Preliminary communication

CAUSES AND EFFECTS OF THE GLOBAL DECREASE IN DEMAND

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Abstract

The current economic crisis has been lasting too long, and particular examples of economic growth and unemployment reduction in some countries have not been the accelerator sufficient for the global recovery. The general level of demand is low, hence so are the investments, although the most powerful economic factors, i.e. the highly developed countries and transnational companies, have the capacities for new investment cycles.

This work analyses the causes and effects of decrease in demand, as well as the options available for removal of those causes and revitalization of the effects.

One of the main causes of decrease in demand in a long run is the asymmetrical distribution of income which has led to a reduction in purchasing power of a large number of consumers, high debt level and change in demand structure. An additional problem, which can be regarded also as a cause of decline in demand in the short run, is the austerity policy which is being implemented both where necessary and conditioned and where voluntary albeit not necessary.

In order to overcome the problem, it is necessary to increase and maintain demand, first initially and then permanently, which is where the state plays an important role.

Keywords: economic crisis, demand, consumption, asymmetrical distribution, employment, investments.

Jel Classification: E41, J2, G01

INTRODUCTION

In different economic papers, the 1929–1933 crisis is often referred to as the Great Economic Crisis or the Great Depression because the world had not seen a greater one before. It was certainly the greatest crisis since the onset of systematic monitoring of economic flows and since the economics as a science had started looking at such phenomena. It was the greatest one also because it affected almost the entire globe, leaving dire effects in its wake, primarily in the form of sluggish economic activity, while causing high unemployment rates over a prolonged period of time.

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There have been a lot of discussions among economists on the Great Depression that hit the world and different opinions as to the ways of overcoming the resulting difficulties. There is no doubt that the most prominent among them was John Maynard Keynes. It seems that there is no dilemma that Keynes' views were key to overcoming the Great Depression; also, there is no doubt that his *General Theory of Employment, Interest and Money* introduced into economics a new direction and marked the entire 20th century (Vukmirica 2012). A lot of time has passed since Keynes' General Theory was first published, many new books in the area of economics have been written and since WWII to the beginning of the 21st century, the world has seen more or less dynamic economic development (with several small-scale episodes of economic stagnation). And then the current world economic crisis hit, the causes of which have been discussed in many paper, but only few options for its overcoming have been offered. As if the abundance of new books made the world forget the old books. In certain circles of politicians and economists, different interpretations can be heard, which do not find the causes of the crisis in the attempts of some market players to make high profits no matter what.[2] However, we believe these to be merely attempts to put the blame on someone else and justify and preserve the privileged positions of individual powerful economic players.

Since the onset of the economic crisis in 2007 to date, during this period of depression, the global economy has seen cyclic movement. And just when it seemed that the crisis is a thing of the past, most of the world saw a new decline of economic growth rates, while the key global economies saw increasing unemployment rates. Although end-2011 and early 2012 saw positive economic growth indicators, the crisis was not over yet. If we look at 2012 Q4, we shall see that the GDP and industrial production rates in Japan dropped by 0.1 per cent and 7.9 per cent respectively; industrial production in the US fell by 0.1 per cent, while labour intensive industries saw dropped 0.4 per cent. The European Union's GDP dropped 0.6 per cent, where the decline was observed in the three key economies of the Union: Germany 0.6 per cent, France 0.3 per cent and Italy 0.9 per cent. In 2013 real GDP growth rate in the U.S. was 1.9%, Japan 1.5, but growth slowed. In the EU real GDP growth in 2013 was only 0.9%. In the Euro area was -0.4%.[3]

Some authors refer to this phenomenon as "a double-bottom crisis" or "a W-shaped crisis", although it is actually a euphemisms for a number of failed attempts at ensuring a more viable recovery. This is because the actual meaning of the double (or multiple) bottom should symbolise the strength and reassurance that there will be no further downward trends and that there exists a robust foundation for a safe suprastructure. As the things stand now, it seems likely that the bottom of the crisis might be multifaceted and more in a "www" shape. Let us hope that the forecasts are wrong; however, by the look of it and given the therapy proposed, it seems that the prosperity of the global economy might see the 80th anniversary of the above mentioned Keynes' General Theory, which will come "as soon as" in two years' time from now. Very serious people, as Paul Krugman calls them sarcastically, will say that to compare this crisis with the Great Depressions it to lack good manners and that it is not the Great

[2] In his paper entitled „Seven myths about the global economic crisis" Prof. Jovan B. Dusanic explains this phenomenon.
[3] European Commission – EUROSTAT.

Depression that is on the stage now, at least not for the majority. However, they should look at the entire European area to the south from the Alps (Portugal, Spain, Italy, Greece, Croatia, Bosnia-Herzegovina, Montenegro, Serbia, Cyprus, Bulgaria and even Slovenia) or many other EU and non-EU countries, which find it only too difficult to cope with the challenges of the sluggish economic activity and high unemployment, huge debt and deficit. However, the situation is more similar to that described by Keyens at the time of the Great Depression. Indeed, the chronic condition of low economic activity over a prolonged period of time with no obvious trends of improvement or complete collapse is evident. This state of affairs actually demonstrates why - as should be case - interest in Keynes and his General Theory has resurged because “free market forces”, primarily in the financial area, have been the cause of the worst financial and economic crises over the past two centuries.

This brief reference to Keynes and the anniversary of his major book is a very important illustration of how some evident ways out of a crisis are not actually used albeit some economists will insist on them, including Nobel Prize winners such as Paul Krugman and Josef Stiglitz. This shows that political elites, even in intellectually advanced settings, are prone to opportune behaviour, i. e. to promote such truth that will serve the more powerful and to advocate solutions that are beneficial to the rich, not helping those in most need.

This paper does not aim to look at all causes of the crisis and reasons for its spreading, nor do we seek to provide a comprehensive solution for complete economic recovery. The overall demand level has declined in the circumstances of the crisis, but it is exactly the insufficient demand that can account for the sluggish dealing with the difficulties. This paper will cast more light on some causes of declining demand and, starting from there, recommend possible solutions of the problem. Demand has been plummeting for a while as the purchasing power of a large portion of the population has declined as well. It is true, however, that it has not declined in those who share the small percentage of extreme wealth, as well as in some fast-growing economies, but in the case of the latter, it is primarily due to the low starting base.

CAUSES OF DECLINING DEMAND

Economic growth, if any, has remained slow in the most countries of the world even five years after the crisis broke out. Unemployment is high and still increasing in many countries. Investments are at a low level although trans-national companies are making high profits. Why? The answer is evident, because it is not reasonable to produce commodities no one demands. That is the market. In order for economic activity and hence employment to boost, which would mean exiting the crisis period, it would be necessary to increase demand. However, in order for this obvious solution for overcoming the crisis to be plausible as well, we need to answer two key questions. The first one is: who can and should increase demand? And the second one is: what type of consumption could help overcome the crises for good?

Higher consumption may seem to be a hasty solution if we know that many countries, firms o citizens found themselves in the crisis exactly because they had been spending more than they actually should for years, i. e. beyond their income. Indeed, we should not forget that our consumption is someone else’s income and that the situation in which everyone restrains from consumption will not lead to higher income and stable growth rates (Krugman 2012).

In order to answer the above questions, we need to go back to the causes of declining demand. Total consumption encompasses public spending and private consumption (Babic 1998). In some countries, for example in Germany, public spending has been restricted due to the austerity policies promoted by the governments of such countries, although it is not absolutely or at all necessary. It is not necessary because the levels of debt and budgetary deficit in those countries are acceptable, which means that they are not an issue in respect of their economic functioning and development. In other countries, like Greece or Spain, public spending has been restricted out of necessity, since the current levels of debt and deficit are too high, and moreover, the assistance is conditioned by belt-tightening. Some countries are faced with what is known as *asymmetric shocks*, which are imminent to monetary unions of countries at different levels of development (De Hrouve 1990).

Private consumption has been reduced in the circumstances of the crisis mainly due to the decline of personal income, which is to a large extent supported by increased unemployment. If we look at the United States of America, and the situation is quite similar in other countries as well, we shall see a significant decline of household income, i. e. wages.

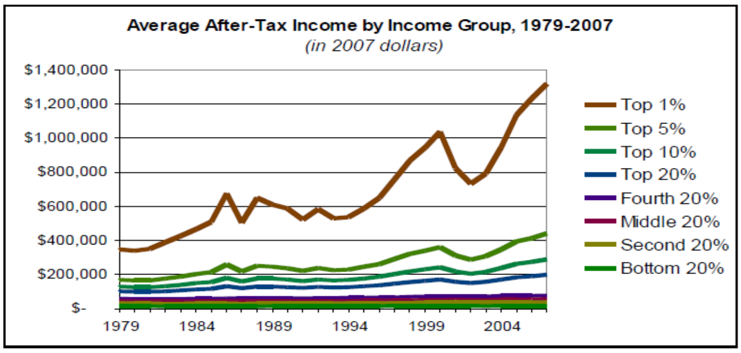
Figure 1. Corporate profits and wages as a share of the GDP in the US[4]

The line representing the ratio of corporate profits and GDP has an upward trend, and the growth was particularly intensive at the beginning of the 21st century, except in the recession years. Also, what is evident is a rapid (surprisingly so) recovery of profits after 2009. The second line, representing the ratio of wages and GDP has generally had a downward trend since the 1970s and is currently at its historical minimum.

Such wage trends in the majority of the population have certainly had detrimental effects on consumption and demand. This has further led to reduced private investment activity, i. e. decline in investment spending, since no one ever invests in the production of undesirable commodities. On the other hand, private consumption dropped due to the redistribution of income or asymmetric distribution in favour of the rich and to the detriment of the so-called middle class and the poor. The concentrated high income in the hands of a small number of non-investors inevitably leads to the

[4] Source: Businessinsider.com http://www.businessinsider.com/corporate-profits-just-hit-an-all-time-high-wages-just-hit-an-all-time-low-2012-6 (accessed June 16, 2013).

reduction of overall consumption (Dusanic 2009) because consumption is not sufficiently dispersed, either in terms of type of dynamics.

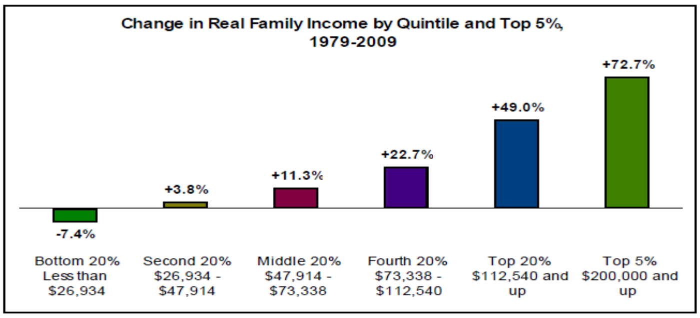


Source: Congressional Budget Office, Average Federal Taxes by Income Group, "Average After-Tax Household Income," June, 2010.

Figure 2. Average After-Tax Income by Income Group in the USA

The income of the 1 per cent of the richest has seen the fastest growth in the period before the crisis outbreak in 2007. That the trend has continued and even intensified is corroborated by the fact that 93 per cent of the income generated in the period following recovery, as the US refers to the post-2010 period, belongs to 1 per cent of the richest Americans. In 2010, out of a total of 15 600 000 US households, 37 per cent of all profit was concentrated in 15,600 households or 0.1 per cent of the top richest. An absolutely unbiased and highly respectable organisation as the Congress Budgetary Office (CBO) produced a report showing increasing of inequalities in the American society over the past 30 years. According to the report, 20 per cent of the rich has seen a rise in their income of 65 per cent, whereas the income of 20 per cent of those at the bottom of the scale rose by only 18 per cent over the same period. However, for 1 per cent of the richest, income took off by 277.5 per cent, whereas 0.1 per cent and 0.01 per cent groups earned even more (Krugman 2012).

Such gap in the income growth, in particular of the rich, is in no way marginal in respect of the volume and structure of demand. There is no lack of demand for luxury and specific commodities but it is not enough to ensure stable economic growth. The demand structure can be changed by the asymmetric distribution of income where the rich get even richer and the poor are pauperised. Of course, if the process continues over prolonged period of time, the latter, whose income is below the average, will increase in the number, which will multiply the decrease of the overall purchasing power. Some studies show even more disappointing figures concerning the income growth. Over the past thirty years, the income of the top 5 per cent rose by as much as 7.2. per cent, whereas the income of the bottom 20 per cent declined by 7.4 per cent. Generally, the poorer half of the population did not see any significant increase of income in the observed period.



Source: U.S. Census Bureau, Historical Income Tables: Families, Table F-3 (for income changes) and Table F-1 (for income ranges in 2009 dollars).

Figure 3. Change in Income Growth, 1979–2009

In the event of such asymmetric distribution as shown in the Figure 3 above, continuous demand for the commodities of mass use, such as the consumption goods, cars, apartments and the like, is simply impossible. It should be clear that €100 million demand, which entails demand for products such as: priceless diamond necklaces, unique items from the ancient times or middle ages, specially commissioned yacht and a tourist trip to the outer space do not impact the production and employment levels as the same-value demand for one million apartments or two million cars. There is no doubt that where inequalities are greater in terms of wealth distribution and concentration among those belonging to a close circle, demand for the goods and services is lesser than where distribution is more just, which inevitably leads to a slow-down of the economic growth and employment rates. It has been demonstrated that when the inequalities reach critical points, they lead to serious economic crises (Dusanic 2011).

HOW TO BOOST DEMAND?

It is clear that saving, be it forced or voluntary, is supportive of low economic activity. Saving policies must change. If we do not need saving, and nevertheless need investments, then the solution of this enigma is investment spending that will support employment increase but not burden the budgetary deficit in the future. Therefore, economically viable public investments. This is the answer to the question about what type of spending could provide an initial impetus for finding a way out of the crisis.

The next question that needs answering is: who can boost initial demand through public investments, which will be a future footing for the efficient production in the private sector? They are primarily states without any debt problems, or whose debt is not too high. They are countries that are not in the state of debt crisis, whose public debt level is not too big a burden for their economy. Debt to a certain level will not burden an economy if its GDP is increasing, if the country has a robust export sector and if the creditors are not predominantly foreign. So, which countries? Those groups of countries that vitally influence the global economic developments and can spur getting out of the crisis. One group includes strong world economies such as the USA, Germany, Japan and Canada. Another group includes fast-growing large-scale economies such as China, India, Russia and Brazil, whereas the third group includes small, but highly developed and stable countries or those that are catching up with the most developed ones at a relatively fast pace; they share some common features, such as: a high rating, a robust export sector and relatively mild detrimental effects of the current global developments, and can be found on every continent: Switzerland, Austria, Nordic countries, South Korea, Singapore, Argentina. South African Republic, etc. We should bear in mind that for discussions on debt, it is not just its absolute size that matters, not even its share in the GP, but the possibility of debt servicing, which affects the structure of the economy, the structure of debt, who the creditors are and where funds that give rise to the debt are invested. Small underdeveloped countries, whose development depends on foreign investments and export with high unemployment and deficit levels, are in a particularly unfavourable situation. According to the statistics of the International Trade Centre, in the first half of 2009, revenues from export in 49 poorest countries in the world (some of them being monoculture, where only two or three products account for over 90% of export) declined by 43.8 per cent. Their recovery certainly depends on the developments in developed countries, their key partners, be it developed countries, major investors or important export markets.

TWO PITFALLS OF PUBLIC INVESTMENTS

It is clear that while deciding on investments, governments need to take into account the current availability of public goods and future needs for such goods. It has already been noted that public investments must be designed in such a way so as to boost employment and be an impetus and support to future private investments. Many investments in the infrastructure, energy, environment, education and other sectors may be suchlike. However, since new investments generally mean new borrowing in the circumstances of the crisis and budgetary deficits that are immanent to crisis periods, one should be careful for at least two reasons. Investments in public goods, in addition to positively affecting the living quality, often require additional public spending. Public investments in crisis circumstances should not create pressures on future budget deficits, in other words, they must be economically viable. Another pitfall is the rolling of one country’s income over to another country and from the public to the private sector. Therefore, they cannot be an accelerator of further asymmetric distribution because it might be conducive to the boomerang effect, which may prolong the recession. The actions of public investments, resource and capacity mobilisation are very important. Since expenditures of some actors in economic developments are the income of others, public spending conducive to the budgetary deficit often end up as corporate profits (even extra profits at times).

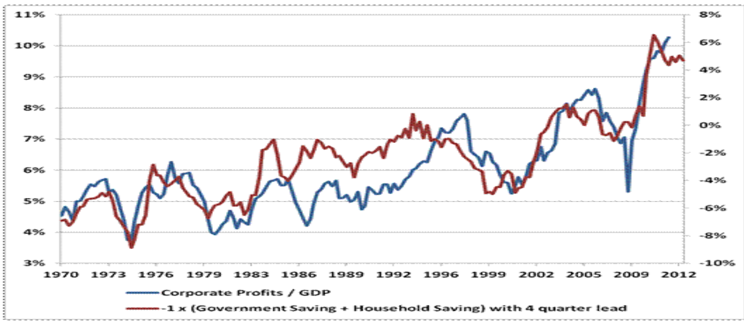


Figure 4. Corporate profits and deficits[5]

These high profits are not of major benefit to countries when they find themselves in difficulties with debt servicing as they are transferred abroad (most often off shore) or simply there is no willingness to invest them for the above reasons. As shown in the chart below, the profit levels of transnational companies are at their peak, including capital reserves. However, many transnational companies do not invest but rather lay off workers in order to reduce costs and preserve high profit levels.

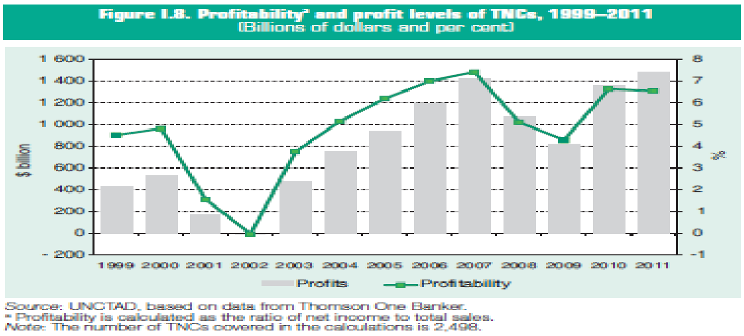


Figure 5. Profit levels of transnational companies 1999–2011

As shown, corporate profits took off in the years preceding the crisis. Once the crisis broke out, profitability declined but in this unstable period of world economy development corporate profits recovered quite soon, while employment, i. e. new jobs, did not. The question is: why would transnational companies want to reduce the staff levels when they make such high profits and capital reserves? Some authors find the answer to this question in an interesting terms: „illusion of cash rich balance sheets“, i. e. a thesis according to which balance sheets must abound in profits. The reasons for such behaviour are manifold, ranging from linking manager’s bonus to the recognised profits (the same managers who have major influence on the recognition of income statements) to the possibility of profit repatriation from one country to another and, in conjunction with this, lower profit tax payments. Whatever the reasons for such behaviour of transnational companies, i. e. global economic powers, this further

[5] Source: Businessinsider.com. http://www.businessinsider.com/corporate-profits-just-hit-an-all-time-high-wages-just-hit-an-all-time-low-2012-6 (accessed June 16, 2013).

corroborates the old saying that economists know the price of everything but can tell the value of nothing.

A PREREQUISITE FOR STABLE GROWTH

The asymmetric distribution that has been on stage over the past decades and accelerated by globalisation, has grown even more asymmetric in the crisis setting. It means that the rich got more from the income distribution since they earned more and got even better-off, whereas the poor got less since on average they earned less. The burden of crisis is not equally shared, which is also another prerequisite of the faster coming out of the crisis. The crisis could be overcome faster and easier if the price of recovery was paid according to the economic power of the participants in respect of income generation and distribution.

A comparative analysis of the burden sharing during the Great Economic Crisis 1929–1933 and the current one unequivocally confirms this. Namely, the burden of the current economic crisis is not directed towards the richest but quite to the opposite.

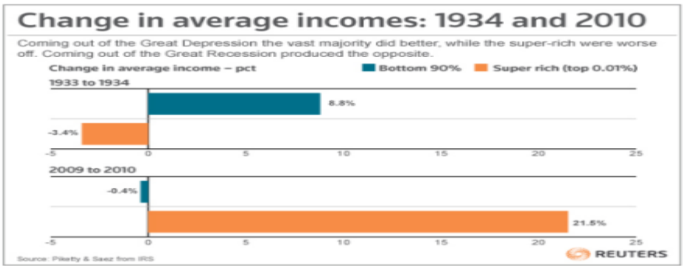


Figure 6. Burden sharing, the Great Depression and the current economic crisis[6]

Without diminishing the influence of numerous factors affecting cyclic economic developments, it does seem that history teaches us also that the asymmetric distribution was and still is a path to crisis periods and vice versa. Analyses clearly indicate the fact that years in which a small group of the rich skimmed the major share of the income were also years followed by greater crisis periods.

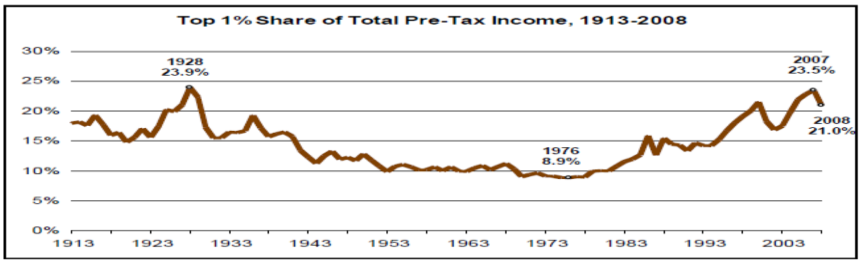


Figure 7. Top 1% share of total pre-tax income in the US[7]

[6] Source: Thinkprogress.org. http://thinkprogress.org/economy/2012/03/16/446012/chart-1934-2010-recovery-ric (accessed June 24, 2013).

CONCLUSION

The cause of the slow overcoming of the global crisis is the low level of investments and public and private sectors. The absence of public investments is caused either by austerity policies or excessive indebtedness of some countries, while the lack of private investments is caused by the decline in the general level of demand. The decline in demand is a consequence of reduced purchasing power of large groups of people due to lower employment on the one hand, and lower income, on the other. In most groups, save for the richest, lower income in the long run is a result of the asymmetric distribution, where the income of the rich is taking off, whereas the income of all others is either stagnating or declining.

Carefully selected, well designed, properly financed and transparently implemented public investments will initially boost demand for the commodities that are subject to the use of the said investments. Subsequently, demand for other goods will increase because employment and income levels will go up as well. This will be a good opportunity for private investments. But, in order for the volume and structure of the general demand level to be preserved in the long run, it is necessary to abandon the asymmetric distribution. Policy change, of course, demands sufficient preparedness of both governing elites and opposing circles. Can the state do his with fiscal, monetary and other tools? Of course they can. And not only they can, but ought to, and not only for the sake of the poor and unemployed, because it is as honourable to get rich as it is to pay taxes.

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[7] Source: Thomas Piketty and Emmanuel Saez, *Income inequalities in the US, 1913-2008, Quarterly Journal of Economics* 118 (1), 2003. Updated in 2008.