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Successful Macroeconomic Stimulus

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Policy Issue

Modern economies can be stimulated by macroeconomic policies that increase purchasing power. If the stimulus is deficit-financed, the resulting increase in national debt can be accommodated within broad limits. In notable cases, such as the US in World War II and Germany in 1930s, massive stimuli led to large increases in output and the virtual elimination of unemployment. During the 1970s, much more modest stimuli eventually led to rising unemployment *and* rising inflation: stagflation. In more recent times beginning with the early 2000s, the initial effectiveness of stimulus policies in Brazil gave way to economic decline and inflation.

What are the conditions that allow for successful implementation of macroeconomic stimulus programmes appropriate for a progressive government?

Analysis

The different outcomes of stimulus programmes depend critically on the effects of stimuli on profitability. Profitability changes in response to the behaviour of the wage share, the movement of real wages *relative* to productivity. If the wage share rises the profit share falls, and this blunts the incentive to invest, which is the excess of the rate of return on new investment over some interest rate representing the alternative to active investment (e.g. the yield-to-maturity on bonds of the same duration as the investment). Reducing interest rates can temporarily offset falling profitability, but lowered profitability implies slower growth and hence a greater tendency for injections of purchasing power to translate into inflation.

In the US during World War II the federal budget rose six-fold, funded through higher taxes and the redirection of private savings to government bonds. The public debt, which was largely internal, rose from 50% of GDP to 120%. Government policy pegged interest rates pegged low in order to keep down the cost of financing the debt (and thus the war). Output expanded greatly and 17 million new civilian jobs were created. At the same time, regulations on prices and wages also kept real wages from rising faster than productivity. Real wages in manufacturing rose by 50%, while industrial productivity increased by 96%. As a result after-tax corporate profits doubled.

In Germany during the 1930s, government policy also held interest rates low. Large budget deficits were also used to expand output and eliminate massive unemployment. Prices, wages and even general business practices were directly controlled to during 1933-1938. As result, despite this unprecedented expansion in output and employment, German real wages *fell* by roughly 25% even as productivity increased substantially. The wage share fell even more, and the profit rate rose fourfold from -7% in 1931 to 15% by 1939.

Post WWII governments of developed countries expressed a strong commitment to maintaining a high level of employment and rising levels of incomes. Policy experience indicated a clear cut trade-off between lower unemployment rates and higher inflation rates (the “Phillips Curve”). By the 1970s the inflation-unemployment relationship had broken down, and both unemployment and inflation rose together, the so-called Great Stagflation. During 1948-1972 the US wage share rose from 53 % to 59%, while the corporate profit rate fell from 18.3% to 11%. The Reagan-Thatcher reactionary economic policies sought to reverse these trends and succeeded. During 1982-2007, real wages were held in check while productivity grew, so that the wage share fell and the profit rate stabilized. At the same time the US central bank rate was reduced, via monetary policy in an unprecedented manner, from 10.7% to 4.4%. A stabilized profit rate and a falling commercial interest rate turned out to be very good for economic growth: *unemployment fell from about 10% to 4.6%.* It was only after this that the financial and speculative bubble, fuelled by low interest rates and lax regulations, burst in 2008.

There are more recent examples of the profitability limits to stimulus policies. In Brazil, two successive Lula governments from 2003-2010 focuses on expansion of mass consumption by incorporating poorer families, increasing the minimum wage, and financing public and private investment in social infrastructure through increased access to credit and subsidized interest rates. Poverty fell, unemployment fell, growth averaged a robust 4%, and *the wage share rose*. Yet from 2011 onward growth fell by half to 2.14% over 2011-2014, and went sharply negative to – 3.8% in 2015 (Carvalho and Rugitsky, 2015).

Policy Framework

The lesson in all of these instances is that a sustainable stimulus policy must not only attend to demand and interest rates, but also to the relation of real wages to productivity. It is not a matter of wage-led vs. profit-led dynamics as putative opposites, but rather of the *sequential* link between the two. “The engine which drives Enterprise is … Profit” (Keynes).

The experience and theory of macroeconomic management therefore implies that stimulus programmes should be accompanied by an incomes policy that provides guidelines for prices and wages, as well as an industrial programme to sustain productivity growth. It should be noted that at the industry level the relation of real wages to productivity also affects real unit costs, and hence affects international competitiveness.

Reference

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Carvalho, Laura and Fernando Rugitsky. 2015. "Growth and Distribution in Brazil the 21st Century: Revisiting the Wage-Led Ersus Profit-Led Debate." *Department of Economics, FEA-USP*, Working Paper No. 2015-25, 1-21.