

The U.S. economy after the boom: a diagnosis - Toward stagnation/slow growth, or worse?

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THE LONG U.S. economic expansion has ended. Whatever the outcome of the current recession, the odds are against a return to the boom conditions of the second half of 1990s. It may indeed be difficult over the medium run to avoid stagnation/slow growth, or even worse.

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The reason, at the most general level, that the world economy, including its leading, US component, appears to face fairly bleak prospects is that it failed during the 1990s expansion to definitively transcend the long economic downturn that had been plaguing it from the early 1970s through the early 1990s. Over-capacity and over-production leading to reduced profitability in the international manufacturing sector - and the failure of successive attempts of governments and corporations to successfully respond to this - have been fundamentally responsible for continuing stagnation on a system-wide scale, and there is as yet little clear evidence that the problem has been overcome. The sharp fall of the rate of profit between 1965 and 1973, and its failure to recover, made for the slowed growth of investment and output over the following two decades throughout most of the world economy, issuing in much reduced productivity and wage growth, as well as high levels of unemployment.

A significant rise of the manufacturing profit rate between 1985 and 1995 did, initially, provide a real basis for the U.S. boom of the 1990s. But the rise in U.S. profitability and, eventually, U.S. economic growth, was paralleled by - and to some extent caused - falling profitability and deep recession in most of the rest of the advanced capitalist world, including Japan and western Europe, during the first half of the 1990s. The sharp slowdown in much of the advanced capitalist world, and

the ensuing threat of disruptive crisis, obliged a fundamental reversal of the US policy from a weak to a strong dollar in 1995. This, in turn, limited the U.S. surge, and, over the second half of the 1990s the manufacturing profit rate fell significantly and, with it, the fundamental basis of the US economic revival.

But even as corporate profitability began to fall between 1995 and 2000 - and in the face of this decline - the stock market took off on the greatest run-up in its history, massively increasing the on-paper assets of corporations and by the rising dollar. The 'wealth effect' of rising share prices thus replaced the revival of manufacturing profitability as the economy's main engine. Corporations found that their overvalued stocks gave them access to almost unlimited financing. On this basis, they were able to sustain a powerful investment boom, and the 1990s expansion was enabled to continue.

Nevertheless, the growing gaps that opened up between rising stock prices and accelerated economic growth on the one hand and falling profitability on the other could not long persist. From the middle of 2000, one after another of the corporations that had led the boom, especially in technology, media, and telecommunications (TMT) confronted disastrous declines in profits, and the stock market crashed. The wealth effect of rising share prices now went into reverse: corporations found it much more difficult to raise money and were forced to cut back on investment, setting the economy on a downward course.

But the overriding problem was the mammoth overhang of excess capacity that corporations had built up during the stock market run up, when they had made use of their of their hugely increased paper wealth to make vast additions to their plant and equipment that could in no way be justified by their rate of return, since profit rates were already falling. Too much capacity made for too much production, and corporations were unable to sell their output at prices that allowed them adequate (if any) profits. Manufacturing profitability, already having fallen significantly between 1997 and 2000, plunged in 2000-2001, making for a profound crisis of the manufacturing sector. This set in motion the classical downward spiral in which declining investment (declining orders for means of production) makes for rising unemployment, which leads to declining consumption demand, which leads to both increased bankruptcies and rising debt defaults, which put further downward pressure on investment, and so forth.

As the U.S. recession deepened, the growth of U.S. demand fell sharply, and the rest of the world economy, profoundly dependent upon U.S. imports, followed the United States downward. As the international economy contracted, U.S. export growth fell drastically, exacerbating the U.S. downturn. A mutually-reinforcing international downturn ensued, with the drop-off in U.S. investment and economic growth from the year mid-1999-mid-2000 to the year mid-2000-mid-2001 the greatest in U.S. post-war history.

Over the course of 2001, the U.S. Federal Reserve brought down interest rates at record-breaking speed and to an unprecedented extent. As a result, household debt exploded upward allowing consumers to continue to increase their spending at a rapid rate. Corporations were thus encouraged to restore their inventories. The frightening tailspin of the economy was stemmed at least for the time being and GDP rose notably during the first quarter of 2002.

Nevertheless, corporate profitability remained at its lowest level in almost two decades, investment continued to plunge alarmingly, exports and the trade/current account deficit continued in crisis, and—reflecting all of this - the stock market was unable to launch a recovery. The outcome thus remained very much in doubt. It is the task of this paper to provide the basis for a firmer understanding of what might be expected next.

Legends of the boom: the official story

The standard account of the US boom makes the “new economy” its point of departure. It focuses on the supposedly unique genius of the U.S. economy. If other countries would only follow the U.S. model, it implies, problems of the world economy would vanish. Nevertheless, this account can derive its rosy picture by focusing only on the five boom years between 1995 and 2000, with no historical context or comparisons; by ignoring the fatal underlying weaknesses of the boom of those years; and by abstracting the US economy from the world system as a whole, to which it was inextricably tied and the problems of which ultimately brought it down.

The new economy as ideology of the stock market run-up

In the official version, enshrined in the Council of Economic Advisers’ Economic Report of the President 2001 (issued in early 2001!), as well as the speeches of Alan Greenspan (available at the Federal Reserve website), the U.S. economy relied on its open markets and its entrepreneurial/financial institutions - particularly its highly developed venture capital companies, its high tech start-ups, and above all its stock market - to launch an epoch making revolution in information technology and achieve a definitive break from the long downturn. The long stagnation of the 1970s and 1980s was thus supposedly the result of a sudden (unexplained and unevidenced) exhaustion of innovation following the post-war boom, which was ostensibly responsible for the long-term slowdown in productivity growth. But with the equally sudden availability of New Economy technologies in the early 1990s, so the story goes, firms that could mobilize the necessary ‘intangible capital’ - in the form of inventiveness, skill, organization and so forth - were presented with unprecedented potential profits. Venture capital companies were thus ostensibly motivated to fund high-risk, high-tech start-ups by their potential for yielding generous rewards, when their stocks went on sale at initial public offerings (IPOs) to enthusiastic investors willing to pay top dollar for shares in what promised to be endlessly profitable info-tech enterprises. Banks were willing to provide these ventures with loans for the same reason.

As Fed Chairman Greenspan never tired of explaining, the promise of New Economy productivity gains thus raised the expected rate of profit, driving up equity prices. Corporations’ rising share values allowed them - especially those in the field of technology, media, and telecommunications - easier access to finance, enabling them to boost investment (the “wealth effect”). More rapid capital accumulation made possible further leaps forward in technology, enabling productivity growth to rise even higher. The latter raised potential profits, thus equity prices, thus investment still more, issuing in what Chairman Greenspan termed a ‘virtuous cycle’ of economic expansion, centred on the stock market and venture capital. In this narrative, the stunning return on Netscape Corporation’s Initial Public Offering in August 1995 announced the vast potential of the New Economy. It thereby set off the mutually supportive stock market run up and economic boom. The synergy between stock market and real economy produced what the Council of Economic Advisers insists on calling the ‘extraordinary gains in performance’ of 1995-2000. (Economic Report of the President 2001, p.23)

The bubble-driven boom

In fact, U.S. economic performance during the height of the boom, from 1995 through 2000, though better than during any other five-year period since the start of the long stagnation in 1973, was anything but extraordinary. In terms of the usual indices, U.S. economic performance in the five years period between 1995 and 2000 did not quite match that in the twenty-five years between 1948

and 1973—and productivity growth, supposedly the source of a U.S. economic breakthrough, was 15 per cent lower.

The U.S. Economy: 1948-1973 versus 1995-2000

(average annual per cent increase, except for unemployment rate)

	1948-1973	1995-2000
GDP	4.0	4.1
Non-Farm Business Net Capital Stock	3.5	3.8
Non-Farm Business Labour Productivity	2.9	2.5
Non-Farm Business Real Hourly Wages	2.8	2.0
Inflation/Consumer Price Index	2.4	2.4
Unemployment Rate (average)	4.2	4.7

Still, had the US boom of the 1990s possessed a firm basis and proved able to sustain itself, it might very well have brought about the definitive transcendence of the long downturn, both at home and internationally. But, the salient fact about the US economic expansion, especially from 1995 through 2000, was that it was ever more dependent upon the stock market frenzy, rather than vice versa, because it proceeded without support from underlying profits. The US's distinctive entrepreneurial-financial institutions, with indispensable assistance from the US Federal Reserve, produced not so much a boom as a bubble.

Venture capital firms did provide a great deal of funding to high technology start-up companies. But their contribution was minimal, until the last years of the 1990s, when the equity price run-up was approaching its peak. At that point, venture capital firms did not have to depend for their returns on these companies actual productive potential or negligible ability to yield profits. They could profit instead from the insanely inflated returns that were being generated by the sale of companies' shares at their Initial Public Offerings. (Economic Report of the President 2001)

Equity investors more broadly did help finance some of these start-ups, as well as other more established information technology companies, by buying their shares. But they did so not because these companies had delivered high profits on the basis of their powerful technologies, but rather because their stock prices were skyrocketing into the stratosphere, driven by speculation. Most E-businesses failed ever to make a profit; and even the leading technology, media, and telecommunications companies (TMT) companies at the heart of the 'New Economy' could not achieve profits that remotely kept up with their equity prices. Corporations did launch a huge investment boom and were thereby able to raise productivity growth. They could do so, however, only because their inflated share prices made access to capital so easy, not because the New Economy had raised profit-making possibilities. A growing gap between stock prices and profits at once drove the expansion, constituted its fatal flaw, and brought it to a screeching halt in 2000-2001, and this is a point to which it will be necessary to return.

The US economy could not, in the last analysis, sustain its profitability and momentum beyond mid-2000 because it remained inextricably bound up with a global economy that remained plagued by stagnation, which resulted from the perpetuation, and exacerbation, of over-capacity and over-production. The underlying weakness of the total system and its US component was manifested in that fact that, during the course of the business cycle of the 1990s, the economic performance of the advanced capitalist economies taken together was, by all of the standard measures - growth of GDP, per capita income, labour productivity and real wages, as well as level of unemployment - no better

than that during the 1980s. The latter was itself less good than that of the 1970s, which did not, of course approach that of the 1960s and 1950s.

Another way of saying this is that, even as neo-liberal, market enabling measures have been ever more comprehensively implemented since around 1980, the economy of the capitalist core has been decreasingly able to deliver the goods, especially to the broad ranks of its population. For the advanced capitalist world as a whole, wage growth during the last decade fell to the lowest level of the post-war period, unemployment rates hovered at or near their post-war peaks (outside of the US), and the welfare state contracted, if at varying speeds. All this was the case, moreover, despite the enormous stimulus artificially imparted to the world economy by the bubble-driven US boom.

Declining Economic Dynamism

(average annual per cent change)

GDP

	1960/69	1969/79	1979/90	1990/95	1995/2000	1990/2000
US	4.6	3.3	2.9	2.4	4.1	3.2
Japan	10.2	5.2	4.6	1.7	0.8	1.3
Germany	4.4	3.6	2.15	2.0	1.7	1.9
Euro 12	5.3	3.7	2.4	1.6	2.5	2.0
G7	5.1	3.6	3.0	2.5	1.9	3.1

GDP per capita

	1960/69	1969/79	1979/90	1990/95	1995/2000	1990/2000
US	3.3	2.5	1.9	1.3	3.4	2.35
Japan	9.0	3.4	4.0	1.1	1.1	1.1
Germany	3.5	2.8	1.9	7.0	1.6	4.3
G-7	3.8a	2.1b	1.9	1.2	2.5	1.8

Labour Productivity Total Economy (GDP/worker)

	1960/69	1969/79	1979/90	1990/95	1995/2000	1990/2000
US	2.5	1.3	1.15	1.2	2.3	1.8
Japan	8.6	4.4	3.0	0.7	1.2	0.9
Germany	4.3	3.0	1.5	2.1	1.2	1.7
Euro 11	5.2	3.2	1.9	1.9	1.3	1.6
G7	4.8a	2.8b	2.55	1.7		

Real Compensation Total Economy (per employee)

	1960/69	1969/79	1979/90	1990/95	1995/2000	1990/2000
US	9.7	2.7	0.7	0.6	1.9	1.3

Japan	7.3	5.0	1.6	0.8	0.2	0.5
Germany	5.1	4.3	1.1	2.0	-0.1	0.95
Euro 11	5.6	4.0	0.8	1.0	0.3	0.6

Unemployment Rate

	1960/69	1969/79	1979/90	1990/95	1995/2000	1990/2000
US	4.8	6.21	7.1	5.9	4.6	5.25
Japan	1.4	1.7	2.5	2.9	4.1	3.5
Germany	0.8	2.05	5.77	8.2	8.6	8.2
Euro 15	2.3	4.6	9.1	9.8	9.9	9.9
G7	3.1a	4.9b	6.8	6.7	6.4	6.6

Non-Residential Capital Stock (private business economy)

	1960/69	1969/79	1979/90	1990/95	1995/2000	1990/2000
US (net)	3.9	3.8	3.0	2.0	3.8	2.9
Japan (gross)	11.3	9.5	6.9	4.5	5.3d	5.0
Germany (gross)	6.6	4.5	3.0	3.1c		
G7 (gross)	4.8	4.6	3.9			

Notes: a - (1960-73) b - (1973-79) c - (1990-93) d - (1995-98)

US revival, international stagnation, 1985-1995

Because the global economy during the past decade proved unable to decisively transcend the long downturn, the long downturn must remain the point of departure for understanding its recent and future trajectory. In this respect, the actual story runs more or less in the opposite direction to the official one. There is thus little evidence indicating a fall-off of the rate of technological advance, of the appearance of new inventions, in the 1970s and 1980s. There is, however, irrefutable evidence in these years of continuing, deeply reduced profitability, especially in the U.S. and international manufacturing sector. The latter goes a long way toward accounting for the long-term slowdown of capital accumulation, and it is slowed investment that must bear a large part of the responsibility for the long-term system-wide slowdown of innovation and productivity growth.

The long downturn

Briefly, and schematically speaking, in the later 1960s and early 1970s, the intensification of international competition, driven especially by the stepped-up entry of lower cost producers based especially in Japan but also in western Europe, brought the long post-war boom to an end. It did so by making for system-wide over-capacity and over-production and precipitously falling profit rates in manufacturing system-wide, which were largely responsible for a major decline in profitability for the advanced capitalist economies as a whole. Sharp reductions in the manufacturing profit rate hit the US first during the second half of the 1960s, bringing down aggregate manufacturing

profitability for the G-7 economies taken together. With the deep devaluation of the dollar of the early 1970s, and corresponding appreciations of the yen and mark, Japan and Germany came to shoulder a significant share of the overall profitability fall.

During the course of the 1970s, over-capacity and over-production actually worsened. Firms across the world economy tended to try to respond to profitability and competitiveness problems by stepping up investment in their own lines, rather than switching to new ones. This was because they possessed huge amounts of "proprietary capital" - ties to suppliers and customers and above all technological capability - that they would not have been able to make use of in other industries. But the result was to re-produce, and exacerbate, the initial problem. At the same time, firms based in the newly-developing economies of East Asia - and to some extent Brazil, Mexico, and others as well - found they could enter certain lines at a profit despite over-capacity, and this exacerbated the initial situation. Only the public subsidies to demand that resulted from Keynesian deficit spending throughout the decade of the 1970s prevented the onset of deep crisis.



At the start of the 1980s, in the interest of fighting inflation and restoring profit rates, the US, and other advanced capitalist states, sought to combat the international over-capacity and over-production that was the legacy of the Keynesian era by introducing high interest rates and deep austerity. These measures were designed, in the first instance, to raise unemployment so as to reduce wage growth. But they were aimed as well to shake out the great ledge of high-cost, low profit means of production that was holding down profitability. Nevertheless, the immediate result of their implementation was the outbreak of the debt-crisis in the third world, accompanied by serious recession that threatened depression in the US. Keynesianism had to be re-introduced with a vengeance, in the form of Reagan's massive military spending and tax cuts for the rich.

The combination of tight money and high government deficits that prevailed in the US was indispensable in keeping the advanced capitalist economies turning over. This was especially because most of these economies had introduced harsh wage and social spending cutbacks that reduced domestic demand, rendering them increasingly reliant upon exports and, in the last analysis, the stimulus provided by US spending. Nevertheless, the US policy mix also slowed the shakeout of redundant and high cost plant and equipment and labour that was still required to restore profitability and - most important - it drove up real interest rates. The advanced capitalist states were clearly unwilling to sustain the sort of severe depression that had, in the past, served to eliminate superfluous means of production and labour and to provide the foundation for a new upturn. But the price of economic stability was record-high costs of borrowing, which, in combination with still reduced profit rates, reined in capital accumulation and economic growth, which remained heavily dependent upon government deficits, through the end of the decade.

With the potential for good returns from investment in new plant and equipment so sharply reduced, capital lurched during the course of the 1980s sharply in the direction of finance. But with the real economy producing such small surpluses, it was not easy to profit through lending or speculation, except with the direct or indirect help of governments - as, for example, via government borrowing at high rates of interest or by exploiting the opportunities for corruption that came with government de-regulation and privatisation programs. By the end of the decade, a huge bubble in commercial real estate had gone bust. The leveraged mergers and acquisitions craze, no doubt the defining

aspect of the 1980s financial expansion, had also collapsed in ignominy. Deeply indebted corporations and profoundly exposed banks were thus left in precarious condition, very much exacerbating and extending the recession that hit in 1990. Economic stagnation thus perpetuated itself into the first few years of the 1990s.

US manufacturing recovery

Against the background of still much-reduced rates of return and slowed growth internationally, between 1986 and 1995 the US manufacturing sector, and thereby the private economy as a whole, achieved a striking recovery of profitability and, ultimately, vitality. It did so by taking a leaf from the book of its leading international rivals in Germany and Japan, achieving a powerful revival of international competitiveness and exports. But US manufacturers did not increase their competitiveness and profitability by means of stepped up investment in aid of rising productivity - at least not until very late in the game. They did so instead by means of the classical capitalist mechanisms of shakeout of high cost, low profit means of production and re-distribution of income away from both labour and their overseas rivals.

In the extended cyclical downturns of the first half of the 1980s and the first third of the 1990s, US corporations shed huge masses of high-cost, low profit means of production and, especially labour, and thereby began a revival of manufacturing productivity growth without the assistance of investment growth. They benefited, too, by holding real wages virtually constant during the decade after 1985 and taking advantage of Reagan administration tax breaks that enabled them to sharply reduce the share of taxes in profits. Over the same period, they were also able to profit mightily from the devaluation of the dollar by 40-60 per cent with respect to the mark and yen. This realignment of currencies was detonated in 1985, when the US obliged its main allies and rivals to agree to the Plaza Accord, which called for bringing down the dollar from the heights it had reached during the first half of the decade. Finally, from the time it entered office in 1993, the Clinton administration sought to balance the budget. In this way, it reduced the growth of aggregate demand and thereby helped somewhat to bring down both inflation and long term interest rates, further improving competitiveness while also putting further downward pressure on wages.

Between 1985 and 1995, the US manufacturing sector increased its rate of profit by about two-thirds. It thereby succeeded in raising profitability for the private economy as a whole above its level of 1973 for the first time in more than 20 years. The take-off of US manufacturing profitability was deeply dependent upon an extraordinary recovery of US manufacturing competitiveness, and exports rose more quickly over the decade than they had during any previous ten year period in the post-war epoch. The most important outcome was the transcendence of the long period of manufacturing investment stagnation. From around 1994, capital accumulation sped up and productivity growth leaped forward, amplifying the rise in profitability and setting off the expansion of the 1990s.

Japanese and West European manufacturing impasse

In an ideal world of mutually complementary specialized productions, the revitalization of the US economy might have ended up propelling the world economy into a new era of growth. But, before the mid-1990s, in the actual world of manufacturing over-capacity and redundant production, the US recovery not only imparted little increased dynamism to the world economy, but came to a large extent at the expense of the economies of its leading competitors and trading partners, especially Japan and Germany. This was because, right up until the end of 1993, it took place against a

background of continuing international over-capacity and over-production in manufacturing.

US producers thus secured their gains in profitability primarily by means of the falling dollar and essentially flat real wages, as well as reduced corporate taxation, but without the benefit of much increase in investment. In what turned out to be pretty much a zero-sum game, they raised their rates of return by reducing costs so as to successfully appropriate market share from their rivals, while imposing upon them their lower prices. But they generated in the process relatively little increase in demand, either investment demand or consumer demand, for their rivals' products. When the US government moved in 1993 to balance the budget, the growth of US-generated demand in the world market received an additional negative shock.

As the opposite side of the same coin, from 1985 the manufacturing economies of Japan, Germany, and elsewhere in western Europe faced an ever intensifying squeeze. Their rising currencies, as well as their relatively fast wage growth, made for declining competitiveness, thus increased downward pressure on already reduced manufacturing profit rates and capital accumulation. Meanwhile, the declining growth of investment, consumer, and government demand throughout the global economy issued in stagnating purchasing power for their goods at home and abroad, most especially in the US. These economies could thus avoid neither intensifying problems during the second half of the 1980s, nor severe crisis during the first half of the 1990s, and, from 1991, they entered into their worst recessions of the post-war epoch. By mid-decade, as the yen rose to 79 per dollar, its highest level of the post-war epoch, Japanese manufacturers could barely make a profit, and the Japanese economy began to freeze up.

The stock market bubble as engine of the expansion, 1995-2000

By spring 1995, the rising yen had begun to threaten international economic stability. The US government, recently traumatized by the Mexican Peso Crisis with its associated Tequila Effect, felt it had no choice but to bail-out the Japanese manufacturing economy. It did so in much the same way that the Japanese and German governments had bailed out a crisis-bound US manufacturing economy in 1985 - by engineering, in collaboration with the other G-3 powers, a new rise of its currency. The so-called reverse Plaza Accord of summer 1995 marked a turning point for the world economy, as the ensuing ascent of the dollar, as well as the East Asian currencies tied to it, and parallel decline of the yen and the mark, initiated a epochal shift away from the pattern of international economic development that had prevailed for the previous decade.

Declining profitability, rising equity prices

As the dollar began to rise from the latter part of 1995 after a decade-long descent, the weight of continuing international over-capacity and over-production in manufacturing shifted away from Japan and west Europe and back toward the US. The revalued currency thus immediately cut short that extended rise of US manufacturing competitiveness that had underpinned the US profitability revival. In 1996 and 1997, the US manufacturing expansion did manage to sustain itself, as output shot up, productivity growth accelerated, and costs of production fell impressively. Nonetheless, US manufacturing lost vitality, because squeezed between the intense downward pressure on prices that was resulting from the surfeit of international manufacturing supply and its own rise in relative costs that was resulting from the rising currency. Indeed, had US manufacturers not succeeded in actually reducing real wages in these couple of years, manufacturing profitability would have started to fall right then. As it was, a serious fall-off would not be long incoming.

Meanwhile, in 1995, under the terms of the Reverse Plaza Accord by which the G-3 powers had agreed to the great turnaround of the dollar/yen/mark exchange rates, the US, German, and especially the Japanese government let loose a huge flood of funds onto US money markets to drive up the dollar, mainly through the purchase of US Treasury instruments. East Asian governments, as well as hedge fund speculators from around the world, followed suit. As a result, US long term interest rates fell sharply, at the same time as the Federal Reserve pushed down short term interest rates (to help combat the Mexican Peso crisis).

The enormous easing on financial markets that thus took place in 1995, as well as the rise of the dollar itself, detonated the great stock market run-up. Hitherto - between 1980 and 1995 - US equity prices had risen significantly, but no more than had corporate profits. Up to 1995, in other words, the rise of the stock market had been fully justified by the underlying increase of corporate profits. But, henceforth, equity prices left corporate profits in the dust, especially as the manufacturing profit rate ceased to rise and turned down, and the biggest stock market bubble in US history blew up.

If the international financial shifts of 1995 set off the stock market run up, Alan Greenspan and the corporations themselves perpetuated it. By late 1996, Greenspan was publicly voicing worry about the "irrational exuberance" of share prices. But he was clearly even more concerned, in private, about the possible stumbling of the US economy, especially as the dollar rose and economic growth at first proved hesitant. Greenspan thus made no attempt to control the enormous increase of liquidity that resulted from the influx of foreign money and his own reduction of interest rates. In fact, aside from a one-quarter point increase in early 1997, Greenspan failed to raise interest rates between the beginning of 1995 and the middle of 1999, with the result that during the second half of the decade the money supply increased at quadruple the rate it had during the first half. Greenspan's loose money regime had the effect of pushing up the stock market further and, not accidentally, stoking the "wealth effect" - i.e. endowing corporations and households with the increased paper wealth that allowed them to borrow more easily, as well as, in the case of the corporations, to issue shares at inflated prices, and on that basis to step up their investment and consumption, buttressing the economic expansion.

US corporations were quick to exploit the easy money gifted by Alan Greenspan. Between 1995 and 2000, they increased their borrowing as a fraction of corporate GDP to record levels, not mainly to fund expenditures on new plant and equipment, but primarily to cover the cost of buying back their own shares. In this way, they avoided the tedious process of creating shareholder value through actually producing goods and services at a profit, and directly drove up the price of their shares for the benefit of their stockholders, as well as their corporate executives who were heavily remunerated with stock options. US corporations were the largest net purchasers on the stock market between 1995 and 2000.

The wealth effect of rising equity prices

The runaway stock market allowed the US expansion to continue and accelerate in the years between 1995 and 2000, even as the downward pressure on the manufacturing profit rate came to deprive the expansion of its initial solid foundation. As the paper value of their assets inflated far beyond any possible underlying economic value, corporations were endowed with vast alternative sources of virtually costless funding, aside from profits. They could issue over-valued shares; they could also secure endless supplies of credit by using the inflated value of their assets essentially as collateral. They were thus able to maintain, even increase, the rate of growth of their expenditures on new plant and equipment, despite the diminishing relative contribution of profits. Thanks to this

“wealth effect,” the expansion achieved increasing vitality.

Limits to the wealth effect

Nevertheless, an economic expansion driven by skyrocketing share prices in the face of stagnating or fall profits had a limited future. The downward tendency of profits was bound to register in the stock market, sooner or later. Once equity prices began to fall, moreover, the wealth effect would go into reverse, and an economy faced with ever-greater over-capacity would plunge.

The international crisis of 1997-1998

Nor were profitability problems and asset bubbles confined, at this juncture, to the US. Between 1985 and 1995, the East Asian manufacturing economies had achieved extraordinary export-based growth, heavily on the basis of the fall in the value of their currencies. These devalued currencies, which were pegged to the declining dollar, endowed these economies with huge gains in competitiveness, and market share, with respect to their Japanese rivals. They also obliged Japanese manufacturers to re-locate much of their low end production to East Asia and to re-orient, in turn, a good part of their capital and intermediate goods exports in that direction as well. But, beginning in 1995, the tables were turned. The same rising dollar that that was both undercutting US manufacturing profitability and helping to drive US equity prices upward also pulled East Asian currencies skyward. The economies of East Asia thus began to experience the same dual trend toward declining manufacturing competitiveness leading to downward pressure on manufacturing profitability, on the one hand, and to an inflow of foreign funds leading to upward pressure on asset prices, on the other, as did the US.

The chain reaction did not stop there. Between 1985 and 1995, in response to the high yen, Japanese producers had reoriented production to East Asia, increasing capital goods exports to the region, while re-locating lower end manufacturing there. When the yen fell from 1995 in the wake of the reverse Plaza Accord, Japanese producers were able to regain domestic market share from their East Asian rivals and force them out of third markets. But, the resulting crisis of East Asian manufacturing could not but boomerang against the Japanese economy, for it deprived Japanese corporations and banks of what had only recently become their best markets. By 1998, Japan had returned to recession.

Nor did the US economy prove invulnerable. In the wake of the bursting of equity price, land, and construction bubbles and the consequent flight of money from the region, the East Asian crisis broke out in earnest in 1997-1998 and was quickly exacerbated by Japan's return to negative growth. US producers lost market share in East Asia and Japan and were hurt by low cost East Asian goods in their overseas and domestic markets. In 1998 and 1999, US exports, having risen at an unprecedented pace for the better part of a decade, suddenly ceased to grow at all, while imports continued to increase at their previous accelerated pace. In the face of such pressure, the US corporate manufacturing profit rate fell by 17 per cent between 1997 and 2000 and was totally responsible for a corresponding decline in the non-financial corporate profit rate of 9 per cent in this period (the non-manufacturing non-financial corporate profit rate did not fall at all).

Meanwhile, starting from mid-1998, US corporate equities began to fall sharply, in response to a decline of corporate profits under the dual pressure of the crisis in East Asia and the inflated dollar. In the wake of the ensuing Russian default and Brazilian crisis, the US descended, in early Autumn 1998, into its most serious economic-financial crisis of the post war epoch. But, if the US went into

recession, much of the rest of the world economy, so dependent upon the US market, might be headed for depression.

The Fed sustains the bubble and the bubble sustains the boom

In September-October 1998, with global financial markets freezing up, Alan Greenspan and the Federal Reserve engineered their famous bail-out of the LTCM hedge fund and lowered interest rates on three occasions. They did so, in the first instance, in order to stop the stock market's descent and combat a crisis that threatened to bring down the international financial system. But Greenspan's goal was not merely short term, to head off equity market and financial market collapse. It was to assure equity investors that he wanted share prices to rise so that the "wealth effect" of the stock market's continuing ascent could keep the US, and world, economy turning over.

What Greenspan was attempting might usefully be called "stock market Keynesianism". In traditional Keynesian policy, demand was "subsidized" by means of the federal government's incurring rising public deficits by spending more than it took in taxes. By contrast, in Greenspan's version, demand would be increased by means of corporations' and rich households' taking on rising private deficits, encouraged to spend beyond their means by the increased paper wealth that was represented by the increased value of their stocks. By 1997-8, the US campaign to balance the budget had reduced deficit spending to zero, and recourse to traditional Keynesian methods was ruled out. In order to stoke investment and consumer demand and thereby counter-balance the worsening decline in manufacturing competitiveness, exports, and profitability, the Fed thus had little choice but to force up the stock market, further increasing the economy's dependence upon the wealth effect.

By virtue of his material reassurances to the equity markets, as well as his paeans to the New Economy, Alan Greenspan pretty much achieved his goals, with epoch making results. Between the end of 1998 and the middle of 2000, the stock market run-up and in turn the US economic boom entered their most fevered phase. With equity prices reaching their highest levels, despite simultaneous fall-off of profitability, corporations all across the economy - especially those in telecommunications, media, and technology (TMT), which enjoyed a disproportionate share of the stock-market increase - gained access to funds practically for free. On this basis, they unleashed a further wave of growth, capital accumulation, and productivity increase, accelerating the expansion still further.

Last but not least, the huge rise in US demand that resulted from the speeding up of the expansion, plus the still rising dollar, rescued the world economy from its crisis of 1997-1998, and incited a new international economic upturn in 1999-2000. The impact of the very rapid growth of US imports was most evident in East Asia, where the unprecedented call for high tech components practically single-handedly drove the NICs, as well to some extent as Japan, from deep recession to rapid growth. But it was also indispensable, for western Europe, where US demand for cars, machine tools, and other products made possible the rapid comebacks of both the German and Italian economies, while the low currency eased Euro area producers' access to third markets.

From stock market crash to recession

The stock market was running over a cliff, but, like the proverbial cartoon character, so long as equity investors refused to look down, to concern themselves about corporate profitability, it could continue to move upward. In the last several years of the decade, the fall in profitability was, for a

time, partially mitigated by big productivity gains secured by manufacturers by means of increased investment growth financed on the basis of their inflated stock values. It was also partially countered by stepped-up consumption growth on the part of the wealthiest 20 per cent of US households, who enjoyed a full 90 per cent of the increase in wealth represented by stock market run-up and were, by themselves, responsible for the historically unprecedented rundown of the US personal savings rate over the course of the 1990s. Nevertheless, the facts that, in these years, even despite accelerated productivity and consumption growth, manufacturing profitability fell significantly and capacity utilization failed to rise, indicate that the build up of excess capacity had already assumed major proportions even as the boom reached its zenith.

The stock market finally began to fall from spring 2000 and then, more definitively, from late summer 2000, when a seemingly endless run of dismal corporate profit reports dramatically deflated equity prices. A huge multitude of e-commerce firms that had never shown a profit collapsed first, as they simply ran out of funds. But, soon the crash consumed almost all of the leading lights of the TMT sector (technology, media, telecommunications), including such stock market darlings as equipment makers Cisco, Lucent, and Nortel and components producers JDS Uniphase and Sycamore. Perhaps a third of total asset values extant in early 2000 have by now gone up in smoke.

As a result of the fall in equity prices, the wealth effect has gone sharply into reverse. With their on-paper assets sharply reduced, firms and households not only have found it more difficult to borrow, but less attractive to do so, especially since the growing threats of bankruptcy and unemployment have led them to look to repair their over-burdened balance sheets. In turn, they have naturally cut back expenditures on capital and consumer goods. But with investment growth falling, productivity growth has had to drop too, putting further downward pressure on profitability.

Above all, the economy has found itself in possession of great masses of plant, equipment, and software, which can in no way be realized, especially as the growth of consumption has plummeted. The resulting over-capacity had succeeded in 2001 in reducing absolute profits (net of interest) in the manufacturing sector by 60 per cent from their 1997 high point, while bringing down the profit rate in the non-financial corporate sector as a whole 25 per cent below its 1997 peak.

Under the impact of the reverse wealth effect and in the face of mammoth excess capacity, the growth of output and of investment fell faster than in any other comparable period since World War II, GDP growth declining from 5.2 per cent in the year ending at mid-2000 to 0.8 per cent (on an annualised basis) in the first half of 2001 and non-residential investment growth from 11 per cent to minus 7.4 per cent over the same interval. It is the collapse of investment in the face of manufacturing over-capacity and plummeting profitability that is at the heart of the recession.

Manufacturing employment and output began to fall immediately and profoundly, in the wake of the stock market crash and profitability decline, hours worked in manufacturing dropping by an astounding 12 per cent from their peak in 1997 to the first quarter of 2002. But it was only from around the middle of 2001 that the US economy as a whole began to fully register the profound shrinkage of its markets that has followed upon these fall-offs of growth and capital accumulation and to take the standard measures of self-preservation. Since that point, US non-manufacturing corporations have been lopping off great swathes of their productive capacity, and, in particular, their labour forces, in an effort to restore competitiveness and balance sheets, placing huge pressure on their rivals to respond in kind. The aggregate effect has been to set off a powerful downward spiral in which falling investment and consumption has led to rising layoffs, bankruptcies and loan defaults, making for further sharp falls in demand, creating the pressure for deepening recession..

As the US entered recession, the rest of the world followed in virtual lock step. The stock market's

last upward thrust had performed the indispensable function of rescuing not only the US, but also the world economy, from the international economic crisis of 1997-1998 originating in East Asia. But with US equity prices and investment collapsing, especially in high technology, the film began to run in reverse. Under the impact of plummeting US imports, the economies of East Asia, Japan, and perhaps western Europe, thus lost steam faster than that of the US. As they did, US export growth has fell even faster. A mutually-reinforcing international recessionary process was the result.

Can expansionary policies stem the tide?

To stem the economy's frightening plunge over the course of 2001, the Federal Reserve lowered interest rates extremely sharply and extremely rapidly. The idea of course was to encourage spending by making the real cost of borrowing exceedingly cheap.

Nevertheless, it should have been evident from the start that this policy would have little direct effect on capital accumulation, the ultimate key to any recovery. Corporations already possessed far too much too much plant and equipment, so had no desire to invest. They therefore wouldn't borrow no matter how cheap it was to do so. In this sense, the Fed was, in Keynes' famous phrase, 'pushing on a string.'

The historic reduction in interest rates has, however, been quite successful, in its main short-term goal -i.e. to spur consumer spending. Super-cheap credit thus has provoked an extraordinary increase of household borrowing, especially by means of the re-financing of home mortgages, even as unemployment has steadily increased. Rising personal consumption has thus single-handedly saved the economy, at least for the moment. In 2001 and the first quarter of 2002 the growth of household borrowing increased faster than at any time during the debt-driven 1990s. This allowed personal consumption expenditures to grow by 3.1 per cent in 2001, and by a whopping 6 per cent in the fourth quarter of 2001. In response to this increase in spending on the part of consumers, corporations began rebuilding the inventories that they allowed to run down as the downturn deepened, and GDP has responded accordingly. It is the causal chain running from the growth of household borrowing, to the growth of consumer expenditures, to the growth of inventories that has been primarily responsible for the major step-up of GDP growth in the fourth quarter 2001 and first quarter of 2002.

Yet, precisely because the recovery has thus been almost solely dependent upon the rapid growth of consumer spending, and behind that, consumer debt, its foundations are very shaky. Non-residential investment growth, the key to economic health, has fallen like a stone - from an average annual rate of 14 per cent in the first half of 2000, to 4 per cent in the second half of 2000, to minus 3.2 per cent in 2001. Export growth has also collapsed - from 11 per cent in the first half of 2000, to 3.3 per cent in the second half of 2000, to minus 4.5 per cent in 2001 (although it began to recover a bit in the first quarter of 2002).

The downward thrust of both investment and exports was responsible for the downward spiral that gripped the economy until late in 2001. It is of course the aim of policy makers to keep consumer spending driving the economy until investment and exports can revive, with investment hopefully recovering under the stimulus of continually rising consumer purchases. But the worry is that the overhang of excess plant and equipment that has been responsible for declining profits will continue to forestall any new burst in investment: indeed, in the first quarter of 2002, non-residential investment fell even faster, by a further 6.8 per cent (on an annual basis). As to exports, although they can be expected to rise to the extent that the US upturn stimulates growth across the rest of the world economy, it is virtually certain that they will lag far behind imports, given how great is the

US economy's propensity to consume. This is sure to put ever increasing pressure on the already record-high US current account deficit. (see below).

How long reduced interest rates can drive consumer spending is itself a critical question. In 2001, the growth of household borrowing as a percentage of GDP reached its highest point since 1980 (except for 1985) and household debt as a percentage of GDP hit its highest level ever, almost 25 per cent above that in 1990. It therefore seems quite possible that, especially in the face of a still worsening employment situation, households will soon have to cut back on their taking on of new debt and thus reduce their spending. That household consumption rose in the first quarter of 2002 at only half the rate it did in the last quarter of 2001 may perhaps indicate that such a slowdown is already in progress. If it is, the nascent upturn is likely to peter out.

Against this background of profound uncertainty, the enormous 'imbalances' that are legacy of the bubble of the late 1990s loom like dark clouds.

i) The record ascent not only of household, but especially corporate, borrowing was central to the boom. But as declining prospects and bankruptcies have loomed ever larger, corporations have sharply cut back their borrowing to reduce their vulnerability. Should this continue to happen on a large scale, a big prop to investment will go by the wayside.

ii) In 2001, the US trade and current account deficits were again at an all-time high, for the third year in a row. Up until recently, overseas investors have been more than willing to fund these deficits, making huge direct investments in the U.S., as well as enormous purchases of U.S. corporate equities and U.S. corporate bonds. But as the U.S. economy in recession has continued to disappoint expectations and the stock market has continued to languish, the rest of the world appears finally to be finding U.S. assets relatively less attractive. In 2001, although foreign purchases of bonds held up, foreign direct investment to buy or establish US businesses fell by a huge 60.4 per cent, while purchases of US shares by the rest of the world declined by more than 35 per cent and another 45 per cent (on an annual basis) in the first quarter of 2002.

As a result of this disenchantment with US assets, pressure on the currency has mounted and, as this is being written (mid-June 2002), the dollar has fallen sharply, especially against the euro. Were these trends to continue, the Fed could soon be faced with an excruciating choice: either let the dollar fall and risk a wholesale liquidation of U.S. properties by foreign investors that could not only wreak havoc in the asset markets, but also set off a real run on the dollar; or raise interest rates and risk pushing the economy back into recession.

iii) Equity prices have obviously fallen a great deal, in response to the worsening business outlook. But paradoxically, their decline has failed to bring stock values back into line with profits, because profits have, in many cases, dropped as far. At the end of 2001, S&P500 index had fallen by more than one third, but the price-earning ratio of the corporations represented there was no lower than it had been at its peak in mid-2000. The same goes for the NASDAQ. Stocks thus remain highly overpriced, and the stock market would therefore appear to have a way further to fall.

To make matters much worse, a stunning succession of accounting scandals have wracked a growing number of the country's leading corporations. These have been marked by top managers' systematic cover-up of company expenses and corresponding inflation of company profits, as well as their personal appropriation of company assets. Many of the firms affected were only recently among the top high-tech stars of the equity markets, including not only Enron, but the telecommunications giants Global Crossing, Quest, and World.com, not to mention Merck drugs and Adelphia cable. These frauds are in no way accidental, but are the unavoidable by-product of a bubble economy that lacked a real base in profits.

Because the stock market run-up was the main force keeping the economy turning over in the face of falling profit rates during the last years of the 1990s, federal officials had every interest in averting their eyes from corporate accounting practices. By the same token, since company executives were driven to maximize "shareholder value" - especially as much of their pay tended to come in the form of stock options - they were under tremendous pressure to conceal the reality of dismal, and declining returns as long as possible. But, they could not of course do so forever, and the inevitable disclosures have devastated investors' confidence and with good reason.

According to a recent report by SmartstockInvestor.com, the corporations listed on the NASDAQ 100 announced profits for the first three quarters of 2001 of 19 billion dollars to shareholders and the media. They did so on the basis of the so-called "pro forma" standards that they are legally allowed to use for this purpose. However, these same 100 companies were could not avoid communicating losses of 82.3 billion dollars for the same period to the Securities and Exchange Commission. This is because, for their profit reports to the SEC, they are legally required to use the rigorous Generally Accepted Accounting Principles (GAAP). Were the stock market to continue to fall, with the economic recovery so fragile, the effect on business confidence and the economy more generally would likely be very depressing, opening up the possibility of a mutually reinforcing downward spiral of both the dollar and asset prices.

Clouded prospects



The bottom line is that the rate of profit, the ultimate key to any recovery, remains very depressed, and the forces that drove it up during the 1990s are gone. In 2001, manufacturing corporate profits fell to their lowest level since 1986. At the same time, the non-financial corporate profit rate fell to its lowest level since 1981. Nevertheless, the dollar remains relatively quite high, keeping down the international competitiveness of US producers, and making any manufacturing profit rate recovery exceedingly difficult. And, of course, the wealth of effect of the stock market boom no longer inflates demand or makes investment nearly costless.

Even as economic growth has accelerated to almost six per cent in the first quarter of 2002, the Federal Reserve has so far failed to raise interest rate, a sign that it is anything but confident that the economy is taking off and the recovery is secure. By the same token, the stock market has continued to stagger, falling back down near its depressed levels of autumn 2001 in the wake of 9/11. Clearly, big business has serious doubts about the consumer-led upturn. Alan Greenspan has declared the recession over. But the economy is far from out of the woods.

Robert Brenner

P.S.

* <http://www.internationalviewpoint.org/spip.php?article392>

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