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WHICH WAY IS THE ECONOMY GOING?(Robert Brenner)
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WHICH WAY IS THE ECONOMY GOING?

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　　本文是美国著名经济史学家、马克思主义者罗伯特・布伦纳**6**月**18**日在中国人民大学中国人文社科论坛上的演讲原稿。布伦纳教授的著作《繁荣与泡沫》的中文版曾由经济科学出版社出版。

Abstract: This paper analyzes recent developments in the economy, and convey some idea of it's direction. It does so, to begin with, by placing contemporary trends within a long term perspective, specifically against the background of the long downturn—the extended period of slowed growth that began around 1973 and continued through the end of th millennium. It argues that the unexpectedly extended period of slowed growth must be understood in terms of the paradoxical persistence of manufacturing over-capacity leading to reduced manufacturing and economy-wide rates of profit. From that point of departure it offers an analysis of the stock market bubble and flawed economic expansion of the second half of the 1990s, the crash and recession of 2000-2001, and the weak and uncertain economic recovery between 2001 and the present

The aim of this paper is to analyze recent developments in the economy, and convey some idea of it's direction. But it is possible to do this, I would argue, only by placing contemporary trends within a long term perspective. For most of the global economy—East Asia is a critical important exception--the post-war epoch thus naturally divides itself into two roughly equal phases: the long boom of the first postwar quarter century, roughly from 1948 to 1973, and the equally extended period of slowed growth that followed, which I would call *the long downturn*. The bottom line is that, for the world economy as a whole, the long downturn continues, extending itself through the end of the last millennium and into the new one. It has done so as a consequence of the paradoxical persistence of chronic over-capacity in the international manufacturing sector, which has been responsible for the persistence of reduced profit rates in manufacturing and the non-farm economy as a whole from the later 1960s right into the present. It is in the context of the perpetuation of the long downturn—and the ongoing problem of over-capacity and reduced profitability--that one should interpret the frenetic boom and stock market bubble of the second half the 1990s, the equity price crash and deep recession of 2000-200, and the weak and precarious cyclical recovery that has ensued.

The Long Downturn

The standard intellectual response to the problem of the long downturn has been, explicitly or implicitly, to deny its existence. Business and government publicists have contended that, since the start of the 1980s, the de-regulation of industry has led to accelerated innovation; the freeing up of financial markets has brought cheaper and more efficient allocation of capital; the destruction of unions has made for more flexible labor markets; the reduction of taxation has made for increasing incentives at the margin both to invest and to labor; and the weakening of state intervention has unfettered entrepreneurship. As a consequence, far from continuing to sputter, the economy has assumed ever increasing vitality, culminating in the economic miracle of the New Economy boom of the later 1990s. More sober economic historians have not sought to deny the reality of reduced dynamism and slowed growth, but rather the need to offer any special explanation for it. From their point of view, the long period of weakened growth manifests a kind of return to equilibrium—to normal, and indeed quite respectable, growth--after what they view as the unique experience of the postwar boom. What really needs to be explained, they contend, is the economy's unprecedented dynamism during the first postwar quarter century, attributable in their eyes to the unusual build-up of pent-up technological capacity during the crisis-bound inter-war period. This, they contend, was exhausted during the long postwar upturn, bringing about a return to normalcy after 1973. In fact, neither of these views remotely corresponds to the economy's actual trajectory during the past three decades.

The contention, so dear to the hearts of neo-classical economists, business advocates, and neo-liberal politicians, that the turn to ever freer markets and ever deeper austerity has brought ever greater economic vigor is in defiance of the evidence. The fact is that, for the advanced capitalist economies taken together, economic performance, in terms of the main macro-economic indicators, has worsened, decade by decade, since the end of the post-war boom. It was less good during the 1990s than the 1980s, which lagged the 1970s, which was, of course, far worse than that of the 1950s and 1960s. As to the US, site of the supposed stock market-driven high-tech miracle, economic performance during the first half of the 1990s was worse than in any other five year period during the whole postwar era. The unquestionable economic acceleration of the second half of the 1990s did raise the figures for the decade as a whole above those of the 1980s, but was itself obliged to depend in large part on the enormous fillip to both consumption and investment provided by the wealth effect of the historic and ill-fated stock market bubble of those years. Even then, the US economy did no better in the 1990s than in the much-maligned 1970s. Even in the five supposedly miraculous years between between 1995 and 2000, US economic performance was not quite as good as for the twenty five years between 1948 and 1973, when state intervention and regulation, trade union power, the repression of finance, and taxation of corporations were all at their greatest.

Nor can lagging economic performance since 1973 be explained away as an optical illusion resulting from the misleading vantage point of the ostensibly aberrant post-war decades. The postwar golden age in the US was, in historical terms, unquestionably impressive, but it was not in a league of its own, as is evident when compared to the previous long upturn, between 1890 and 1913. The growth of labor productivity, of per capita income, and of real wages was higher in the boom after World War II than that before World War I, although not by all that much. On the other hand, the growth of GDP and of investment proceeded as rapidly or more so in the latter epoch than the former. The boom from 1950 through 1973 thus surpassed the expansion from 1890 through 1913, but it remains reasonable to group them together.

By contrast, the long downturn after 1973 can be clearly and properly identified as such, because its economic performance was so weak, compared not only to that of the post-World War II but also the pre-World War I long boom. It thus fell palpably short of both expansions with respect to virtually all of the main macro-economic indicators--the growth of labor productivity, of

GDP, of GDP per person, of real wages, and of the growth of investment. The long downturn is precisely that…and, lasting through the end of the millennium, far too extended to be passed off as just another down phase of the latest Kondratieff cycle (leaving aside the vexed question of their existence).

Did the onset of slowed growth reflect the using up of technological potential, which had reached unprecedented heights as a consequence of the long drought of investment during the Great Depression and which endowed the economy of the first post-war decades with exceptional dynamism? This appears to be the new orthodoxy among macroeconomists, but is impossible to justify in terms of the actual trends of productivity. There was, in the first place, no exhaustion of technological potential whatsoever in the manufacturing sector. After falling off briefly in the 1970s, manufacturing productivity actually accelerated from 1980 onwards, achieving the highest rate of growth for any ten year period during the postwar epoch during the 1990s. In any case, were the trajectory of productivity expressive of the using up of a technological backlog, one would expect it to have followed a path of gradual, more or less continuous decline. As it was, productivity growth for both the non-farm economy and the non-farm economy *excluding manufacturing* remained high, and remarkably steady, over the long period between 1938 and 1973. It then declined deeply and discontinuously between 1973 and 1980 and did not come close to recovering between 1980 and 2000. If technology capacity was being used up so as to make possible the long boom, why did productivity growth outside manufacturing fail to fall for so very long? Why did it suddenly collapse? And why did stagnate for so very long?

The ultimate testimony to the economy's continuing debility can be read off the trends in income distribution and standard of living. Between 1973 and 2000, the capitalist economy failed to revitalize itself despite securing for its wealthy individuals and the owners of its corporations both the greatest increase in income inequality and the lowest growth in real wages of the entire twentieth century. The income share of the top one per cent of US households by income ascended to its peak in 1929, at around 25 per cent, but then fell steadily across the post-war boom to reach its lowest point in 1973, at about 10 per cent. Yet from this nadir, it rose without cease throughout the long downturn, almost regaining its 1929 level in 2000, at 22 per cent. Meanwhile, after bottoming out at 15.5 per cent in 1973, the income share of the top 5 per cent of households grew by more than a third over the next twenty seven years, reaching a twentieth century peak of 20.8 per cent in 2000. These trends toward mal-distribution found their counter-parts in the trajectories of the poverty rate and of real wages. Between 1959 and 1973, the poverty rate fell from 22.4 per cent to 11.1 per cent. But from 1973 to 1995, it rose to 13.8 per cent and by 2000 was still slightly above its level in 1973, at 11.3 per cent. Between 1980 and 2000, the average annual growth of real compensation in the private sector was right around zero. But this stagnation of real wages should hardly be surprising in view of parallel stagnation of productivity growth, the ultimate indicator of economic dynamism, or lack thereof. In the same two decades, labor productivity (GDP/hour) increased at an average annual rate of just 1.4 per cent (1.5 per cent for 1990-2000). This was barely half that from 1948 to 1969, at 2.65 per cent, and almost 40 per cent below the average annual rate of productivity increase for the entire 90-year period between 1890 and 1980 of 2.3 per cent. Throughout the long downturn, gains for the wealthy and corporate owners have been secured overwhelmingly at the expense of working people and the poor, especially because they have been unaccompanied by any decisive increase in the economy's vitality. .

Turning Point

These days, the long downturn is less denied or explained away than simply forgotten amidst the ongoing celebration——even in the wake of the bust and recession of 2000-2001—of the ostensible rise of a New Economy in the second half of the 1990s. According to the official story,

the US economy, by virtue of its freed up financial markets and its unmatched entrepreneurial cum financial institutions, achieved, during the "fabulous nineties", a breakthrough unavailable to its stodgier counterparts in western Europe and Japan. The US stock market was thus able to hot-house a technological revolution and economic boom by virtue of its ability to single out those companies that promised the best profits due to their technological advance. Institutional investors piled into those firms' equities, driving up their prices, and signaling to bond markets, banks, and equity markets the desirability of lending to them and buying their shares. On the basis of the increased borrowing and stock issuance that was thereby made possible, these same corporations--disproportionately in hi-tech, but also to be found all across the manufacturing durable goods sector and related industries--were enabled to accelerate investment in advance of profits, making for faster productivity growth and even greater potential returns. More rapid capital accumulation allowed for further leaps forward in technology, enabling productivity growth to rise even higher, making possible even higher expected profits, thus more elevated equity prices, thus still more borrowing, stock issuance, and purchases of plant, equipment, and software…issuing in what Fed Chairman Alan Greenspan celebrated as a "virtuous cycle" of economic expansion.

But this analysis has proven topsy-turvy, for the simple reason that, between 1995 and 2000, expected profits never materialized as actual profits. On the contrary, the profit rate plummetted in the US and soon across the world economy, in manufacturing and the non-farm sector more generally, even as the boom blazed on. Rather than setting the US and world economy on a new course, the New Economy actually exacerbated the system's fundamental underlying problem – viz. secularly reduced profit rates resulting from chronic over-capacity in manufacturing and related sectors. Beneath its glossy surface, the mechanisms driving the New Economy brought about the destruction of any chance the US had at that juncture to escape the long downturn, while rendering inevitable the equity price crash and the sharp recession that brought a dramatic denouement to the 1990s' long expansion.

Ironically, during the decade before, between 1985 and 1995, the US had launched a very real and, in its own terms, well-founded recovery, after close to two decades of reduced profitability, worsening performance, and increased economic perturbation. The huge shakeout of high cost, low profit means of production that was detonated by the record high real interest rates and a super-inflated dollar of the first half of the 1980s provided the initial conditions for the US comeback. During the subsequent ten years, the US manufacturing sector was able to take advantage of the radical reduction in the value of the dollar that was set off by the G-5's Plaza Accord of 1985—along with zero wage growth, falling real interest rates, and reduced corporate taxation--to sharply increase its international competitiveness and export growth. On that foundation, it succeeded in achieving an enormous recovery of its profit rate and, in turn, the profit-rate of the non-farm economy, which, thanks to a 70 per cent increase in manufacturing profitability, rose above its level of 1973 for the first time in two decades. By 1992-3, the US economy as a whole had launched a powerful expansion, marked by fast rising output, investment, productivity, and, eventually, employment. This was the *real boom* of the 1990s. Had it succeeded it in sustaining itself, it might have brought an end to the long downturn.

The US economy was however unable to continue with its recovery, because it could not maintain the increased level of profitability that had served as its fundamental enabling condition, due to its imbrication in a global economy that, even by the middle of the 1990s, remained mired in slow growth, or worse, as a consequence of the perpetuation of reduced profit rates resulting from the perpetuation of chronic manufacturing over-capacity on a global scale. . Between 1965 and 1973, the intensification of international competition had projected the G-7 economies from long boom to long downturn by precipitated the onset of over-capacity and falling profitability in the international manufacturing sector. Reduced surpluses vis a vis the capital stock made for the reduction in investment and employment, thereby reduced productivity and wage growth, and, ultimately, a

secular decline in the growth of investment, consumer, and export demand.

Now, according to standard economic assumptions, the resulting oversupply in relation to demand in the manufacturing sector should have been more or less easily and directly overcome by way of normal economic adjustment mechanisms—namely, the reallocation of factors of production out of high cost, low-profit lines into low-cost, high-profit ones--but such expectations of adjustment turned out to be unwarranted. The great manufacturing corporations of the advanced capitalist economies that dominated world production possessed networks of suppliers and consumers and, above all, technological knowledge and capacity for innovation that they had built up over many years. But, these could be wielded only in the lines they already occupied. As a consequence, these corporations typically chose to fight rather than switch, continuing to invest in their own industries in order to improve their competitiveness in order to better compete for their share of the market. At the same time, producers from some regions of the developing world, above all East Asia, were able to combine the most advanced technology with low but relatively skilled wages to profit handsomely by entering one after another manufacturing line industries, many of which were already over-supplied. Much like their Japanese predecessors, first the Northeast Asian NICs, then the Southeast Asian "little tigers", then the Chinese behemoth, flooded the world market with quality manufactures embodying ever greater skill and more sophisticated technique. The combination of insufficient exit, especially in the economies of the capitalist core, plus too much entry, especially in the economies of the developing world, naturally intensified the initial problem and might ultimately have resulted in deeper and more concentrated shakeouts of high-cost, low profit means of production than actually occurred. But government policies of subsidizing demand by way of federal deficits fiscal and monetary policy, reduced the length and moderated the depth of the series of recessions that gripped the world economy starting in 1969-1970, perpetuating rather than dissolving manufacturing over-capacity. The upshot was that slowed growth and reduced dynamism continued to grip the economy. .

Because it crafted its recovery against the background of a relatively stagnant pie and the continuation of reduced manufacturing and non-farm profit rates for the G-7 economies taken in aggregate, the US was thus able to launch its 1990s boom only at the expense of its leading partners and rivals. As the flip side of the US revival, the Japanese, German, and western Europe experienced rising exchange rates and relatively fast rising wages that sharply reduced their international competitiveness, while having to confront the slowed growth of the US market for their exports. Between 1991 and 1995, as the US began finally to take off on the basis of fast rising manufacturing profitability, rates, the manufacturing sectors of these economies sustained unprecedented reductions in their rates of profit which propelled them into deep crisis, and they experienced their worst cyclical downturns of the post-war epoch.

By 1995, with the Japanese economy threatening to seize up in the wake of the Mexican Peso crisis, the G-3 felt obliged, in the interest of system-wide stability, to take collective action to bail out Japan and Germany, in a manner precisely analogous to the way they had rescued the US a decade earlier--by bringing down the value of the yen and the mark. The Reverse Plaza Accord that they negotiated constituted the turning point for the US economic expansion of the 1990s, both setting off the New Economy boom and insuring it would have feet of clay. In keeping with that agreement, the US, the German, and most especially the Japanese government let loose a huge flood of funds onto US money markets, mainly through the purchase of US Treasury instruments. East Asian governments, as well as hedge fund speculators from around the world, followed suit. The resulting demand for dollars drove up the exchange rate against the yen and the mark. The resulting demand for US Treasury instruments drove down long term interest rates over the course of 1995, while the Federal Reserve simultaneously reduced the short term cost of borrowing interest rates (to help insure stability in the wake of the Mexican Peso crisis). The impetuously rising dollar plus the persistently low cost of US borrowing taken together shaped the path of economic development on

a global scale for the rest of the decade.

A New Economy?

As the US currency rose from the latter part of 1995 after a decade-long descent, the weight of international over-capacity shifted once again away from Japan and Germany and back toward the US, as well as East Asia, which, for the most part, pegged its currencies to the dollar. The US manufacturing sector thus saw brutally cut short cut short that extended rise of its competitiveness that had underpinned the US profitability revival.   Stepped up manufacturing productivity growth in combination with relatively slow wage increase actually made for a significant reduction in the growth of costs between 1995 and 2000. But this was more than counterbalanced by the even greater decline in the rise of prices brought on by the surfeit of international manufacturing supply, as well as the relative rise in international costs that was caused by the unending ascent of the dollar. Matters were made much worse for US manufacturers when the East Asian manufacturing economies entered into crisis in 1997-1998. This led to the drying up of East Asian demand, the devaluation of East Asian currencies, and East Asian distress selling on the world market…and, in turn, the return to recession of a Japanese economy that had sought to over-come its own profitability problems during the first half of the 1990s by re-orienting to a now contracting East Asia.   From 1997 through 2000, the US manufacturing profit rate entered into a new decline, falling by 16 per cent. With the manufacturing sectors of the US, the East Asia tigers, Germany, and Japan in deepening trouble, the world economy was placed in increasing jeopardy.   All else equal, one would have expected a slowdown in investment growth, job creation, and GDP, slowing down the cyclical recovery if not bringing it to an end.   But, thanks to the great stock market run-up of the second half of the 1990s the expansion actually speeded up, if only temporarily.

The enormous easing on financial markets that took place in 1995, as well as the rise of the dollar itself, detonated the 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 began to expand.
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If the international financial shifts of 1995 set off the stock market run up, the US Federal Reserve perpetuated it. By late 1996, Alan Greenspan was voicing worry, in public, about the "irrational exuberance" of share prices. But he was more concerned, in private, about the possible stumbling of the US economy, especially as Federal deficits evaporated and the dollar rose, threatening aggregate demand and corporate profits. 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. Meanwhile, the Fed intervened with ever-easier credit at every sign of instability in the equity markets – in late summer of 1997 as the East Asian crisis struck, in early autumn 1998 as that crisis hit the US and financial markets froze up, and ein the autumn of 1999 to head off a potential Y2K meltdown. It was investors' belief in the so-called "Greenspan put" – that the Fed would bail out the equity market come what may – that kept the bubble expanding through the end of the millennium.

The strategy that Greenspan evolved during the second half of the 1990s – and has continued to implement ever since – might usefully be called "stock market, or asset-price, Keynesianism". In traditional Keynesian policy, demand is "subsidized" by means of the federal government's incurring rising *public* deficits so as to spend more than it takes in in taxes. By contrast, in Greenspan's

version, demand is increased by means of corporations' and rich households' taking on rising *private* deficits so as to spend more than they make, encouraged to do so by the increased paper wealth that they accrue by virtue of the appreciation of the value of their stocks, or other assets. By 1997-8, the US campaign to balance the budget had reduced federal deficit spending to zero, and recourse to traditional Keynesianism was ruled out. In order to insure the growth of investment and consumer demand and thereby counter-balance the worsening decline in manufacturing competitiveness, exports, and profitability, the Fed thought it prudent to keep asset prices going up.

In fact, the ascending US stock market and the ensuing wealth effect of rocketing equity prices allowed the US expansion to continue and accelerate in the years between 1995 and 2000, even as downward pressure on profit rates deprived it of its initially solid foundation.. Rising shares themselves called forth a vast inflow of money from the rest of the world, which not only further enhanced their value, but also drove up the dollar even more. The upshot was a kind of scissors between rising asset values on the one hand and mounting over-capacity and a rising currency on the other. The former made possible the accelerated growth of debt and thereby amplified, if only temporarily, the system's capacity to absorb both capital and consumer goods, thereby driving the expansion faster and further; the latter made for declining competitiveness and falling profit rates and thereby under cut it. Although profits were increasingly hard to come by, corporations were able to fund rapid capital accumulation with consummate ease by virtue of runaway stock values that bloated market capitalizations and thus apparent collateral beyond recognition. They succeeded in borrowing at levels previously matched in the post-war epoch only during recessions. Meanwhile, the less credit-worthy among them were able to finance investment to an extent without close precedent through issuing over-priced shares. Corporations were thus able to maintain, even increase, the rate of growth of expenditures on new plant, equipment, and software as the decade wore on, conveying an impression of economic vitality that would instantly evaporate, especially in the manufacturing and related sectors, when the stock market bubble busted. Rich households also benefited from the wealth effect of runaway equity prices. As they saw their paper assets soar, they felt justified in raising their annual borrowing, as well as their debt outstanding, to near record levels as a fraction of household income, and on this basis felt free to raise their household consumption as a proportion of personal income to near 100 per cent, bringing about by themselves a reduction in the US household savings rate from 8 per cent to near zero over the course of the expansion.

Between 1995 and 2000, a powerful boom took shape, driven by the wealth effect of rising equity prices on both firms and households. Investment accelerated and made possible a notable acceleration of productivity increase, especially in manufacturing. Employment growth also speeded up and, in the last few years of the century, made possible, after a long period of stagnation, a significant jump in real wage increase. Simultaneously, consumer expenditures jumped sharply, helping mightily to soak up the increased output generated by rising investment and productivity. But, constrained as it was by a runaway dollar and dependent upon by the wealth effect of rising equity prices made possible by easy credit, the expansion assumed a distorted and contradictory character that would limit its half life. The manufacturing sector, which owed its impressive ascent between 1985 and 1995 to improving competitiveness and fast rising exports, continued to expand briskly on the basis of its access to virtually costless funds, even in the face of a rising currency that reduced its competitiveness, making for downward pressure on exports and an explosion of imports, which was itself further amplified by impetuously growing domestic consumption inflated by the wealth effect. At the same, such consumer-driven industries as home construction, retail trade, hotels and restaurants, and health and education services assumed a dynamism that they had lacked since the 1960s, as they benefited from the astronomical rise of debt and plunging rates of saving. Finally, even as profitability declined across the real economy, the financial sector took off in unprecedented fashion, as virtually every aspect of the new economy was to nurture it.

The Vertigenous Rise of Finance

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The US, and global, economy had begun to turn toward finance at the start of the 1980s, as a consequence of the dismal failure during the 1970s of the attempt on the part of US manufacturers to invest their way out of their profitability problems with the help of the government's deficit spending, easy credit, and dollar devaluation policies. By the end of the decade, not only were unprecedented inflation and mounting current account deficits precipitating runs on the dollar that demanded decisive action if the dollar's status as key currency was to be preserved, but the manufacturing profit rate was languishing at the same reduced level as 1975. The US government's moves at this point, and subsequently, toward financial de-regulation were thus designed precisely to smooth the way for the reallocation of capital out of over-supplied industries in the direction of financial services. But lenders, speculators, and promoters faced a problem. How could they make a killing from firms and households in a situation in which non-financial corporations were producing such sharply reduced surpluses with respect to their capital stock and wage earners were so hard pressed? The US government did, from the start of the 1980s, provide a huge assured field for massive profits to lenders, both in the US and abroad, with its mammoth increase in borrowing at record real rates of interest. But the difficulty of profiting through purely private initiatives in a period of powerful downward pressure on profits in international manufacturing had already been forcefully brought home over the course of the 1970s, when US commercial banks, facing the drying up of opportunities in the core economies, piled into lending to newly-industrializing countries, and ultimately precipitated the catastrophic LDC (Less-developed-country) debt crisis of the early 1980s. The flooding of US Savings and Loan institutions into commercial real estate, which came in the wake of the de-regulation of the thrifts in 1980, followed a similar pattern, leading inexorably to bubble and collapse by the end of the decade.

Nor did the leveraged buyout craze turn out differently. The financial engineers in charge did, at the start, manage to net higher returns by means of massive layoffs, refusing to invest, and running down the capital stock of non-financial corporations, while breaking contracts with unions and cutting off long standing relationships with suppliers. But the resulting gains via once-and-for-all productivity increases and reductions in input costs were soon wiped out, as more investors tried to get in on the action, as stock prices rose ever higher, and as the cost of buyouts rose correspondingly, while crtorporate debt skyrocketed. Nor is there much evidence that the "discipline of finance" served to increase the efficiency of production by facilitating technological advance or reallocating capital from unprofitable to profitable lines. On the contrary, freed up financial markets made possible a massive misallocation of credit to non-financial corporations to enable an orgy of speculation in the form of mergers and acquisitions. By the time the decade was over, the non-financial sector was immobilized not only by depressed rates of profit that had failed to rise above those at the end of the 1970s, but also by unprecedented, paralyzing levels of debt. Meanwhile, commercial banks, which had sought to profit by financing the booms in leveraged buyouts, as well as commercial real estate, found themselves in their worst condition of the post-war epoch, experiencing sharply reduced returns on equity and the greatest wave of bank failures since the Great Depression.

The US financial sector, and particularly its commercial banks, thus entered the 1990s in deep crisis, the legacy of the go-go 80s. But decisive intervention by the Fed made for an astonishing turnaround. With the onset of the recession of 1990-1991, Alan Greenspan not only brought short-term interest rates down dramatically, enabling the banks to pursue with ever-improving results their standard policy of borrowing cheap short-term and lending dear long term. In addition, he allowed banks, in violation of government regulations, to hold onto enormous quantities of long-term bonds without setting aside funds to cover the associated risk These appreciated spectacularly as long-term interest rates declined precipitously. Financial sector profits were restored almost instantaneously and began a vertiginous ascent that extended into the new millennium.

Henceforth, every major trend ran in favor of finance. Non-financial corporations boomed, and stepped up their borrowing. Inflation was suppressed, especially as a consequence of the take off of the dollar and resulting downward price pressure. The Clinton administration pushed banking de-regulation to its logical conclusion, opening the way to the rise of huge conglomerates that combined commercial banking, investment banking, and insurance. The stock market bubble offered historically unmatched opportunities to rake in fees and profits for superintending share issues and mergers and acquisitions, while simultaneously managing the explosion of household and corporate borrowing. Finally, as the decade neared its end, the nascent run-up in housing offered still another huge field for raking in profits. Between 1994 and 2000, financial sector profits *including interest received* doubled, and – because non-financial corporate profits *after interest paid* swooned after 1997 – accounted for a stunning 75 per cent of the *increase* in total corporate profits after payment of interest accrued in these years. Already accounting for 30 per cent of total corporate profits net of interest by 1997, financial profits accounted for 38 per cent in 2000.

The End of the Boom

Nevertheless, the fact remains that the growth of both investment and consumption were themselves ultimately dependent upon an equity price run-up that was powered by speculation in defiance of falling profit rates. Rather than discovering and funding the most promising fields for expansion--as in the fables of the Federal Reserve, the Council of Economic Advisers and orthodox economic theory--the de-regulated US financial sector drove a massive misallocation of funds into hi-tech paper assets and a parallel misdirection of new plant, equipment, and software into over-subscribed manufacturing lines, while extending overcapacity into the heartland of the New Economy, notably computers, chips, telecommunications, and telecommunications components. The accelerating productivity growth that resulted from the stepped-up growth of new plant, equipment, and software, did bring about a slowdown in the increase of costs of production, but this was more than counter-balanced by the even sharper fall-off in the increase of prices that stemmed from the outrunning of demand by supply on a global scale, mainly in manufacturing, not to mention the infernal upward pressure on costs in international terms resulting from the unending rise of a US currency driven ever higher by the insatiable foreign demand for US assets. US consumers and overseas exporters thus ended up as the primary – but only temporary – beneficiaries of a self undermining process that brought both ever increasing current account deficits on the one hand and inexorably increasing downward pressure on profits on the other. To make matters worse, as the expansion achieved record length, real wage growth finally began to accelerate and placed additional downward pressure on profits, especially outside of manufacturing. Between 1997 and 2000, even as the boom peaked, the rate of profit in the non-financial corporate sector as a whole fell by about 15 per cent…opening the way to the crash of 2000 and ensuing recession of 2001.

From July 2000, a series of ever-worsening corporate earnings reports precipitated a sharp cyclical downturn, both by reversing the wealth effect and by revealing the mass of redundant productive capacity and mountain of corporate indebtedness that constituted the dual legacy of the bubble-driven boom. With their market capitalization sharply reduced, firms not only found it more difficult to borrow or issue new shares, but less attractive to do so, especially since declining profits and the growing threat of bankruptcy led them to try to repair balance sheets overburdened by debt. Having purchased far more plant, equipment, and software than they could profitably set in motion, they could not think of adding means of production or labor, but were obliged either to reduce prices or leave capacity unused. Either way, they sustained further reductions in their rate of profit. With not only profits, but also loans, so much harder to come by, it was inevitable that the growth of jobs and new plant and equipment would be cut back, undercutting aggregate demand, and detonating a self-sustaining downward spiral that precipitated a sharp cyclical downturn.

The main, almost exclusive, site and source of the economic slowdown was the manufacturing sector, its profitability decline reaching a climax in 2001. The core of the problem was to be found in high tech lines such as telecommunications components, microprocessors, and computers, but traditional industries such as textiles and steel were also hard hit, as were closely-related non-manufacturing industries, especially telecommunications and business services. In 2001, the rate of profit in the manufacturing sector fell by 21.3 per cent, to a level over a third down from its 1997 peak, while that of the manufacturing durable goods sector, site of all the high tech lines as well as most of the mainline industries exposed to international competition, dropped by 30 per cent and a stunning 46 per cent from 1997. Between 1997 and 2001, as corporate indebtedness rocketed, manufacturing net interest as a proportion of manufacturing net profits rose from 19 per cent to 40.5 per cent, a post-war record. Partly as a consequence, by 2001, manufacturing profits net of interest had fallen a total of 44.4 per cent from their high point in 1997. Although by 1995, manufacturing had come to constitute only 29.3 per cent and 32.7 per cent, respectively, of corporate and non-financial *GDP*, it still accounted for 42.5 and 50 per cent, respectively, of corporate and non-financial corporate *profits* (before payment of interest). As a consequence, manufacturing's descent into crisis meant crisis for the whole economy. Outside manufacturing, there was no fall at all in the rate of profit in 2001; but, due to the drop in the manufacturing sector, the rate of profit for the non-financial corporate sector as a whole fell by an additional 10 per cent, making for a decline of almost 27 per cent between 1997 and 2001.

To counter their declining profitability, starting in the second half of 2000, firms sought to radically cut costs, driving the economy into recession and slow growth by sharply reducing the growth of purchasing power. It was from the manufacturing sector, and related industries, that virtually all of the downward pressures on demand emanated, as manufacturing employers cut back mercilessly in order to restore profits. Manufacturers reduced output by 5.5 per cent in 2001 alone, and even through 2003 real manufacturing GDP had still failed to return to its level of 2000. Meanwhile, capacity utilization fell from 81.5 per cent for 1995-2000 to 73.6 per cent for 2002-2003, lower than in any other year in the post-war epoch, except for 1982 and 1975. The same story held true with respect to investment, as real capital stock in manufacturing grew on average by 0 per cent per year between 2000 and 2003, bringing down the average annual growth of the non-farm capital stock to less than half of what it had been in the second half of the 1990s. Above all, manufacturers profoundly reduced employment. They eliminated 2.98 million manufacturing jobs between July 2000 and July 2004. This was over 150 per cent of the total of the 1.97 million private sector jobs lost in the same period – meaning that the private economy outside manufacturing gained roughly a million jobs. Between 1997, its most recent peak, and 2004, manufacturing sector employment fell by no less than *one-fifth.* The upshot was that, after having increased at an average annual rate of 3.8 per cent between 1995 and 2000, total real compensation in manufacturing fell at the annual average rate of 3.1 per cent between 2000 and 2003, thereby accounting for most of the decline in total real compensation that took place in the business economy during that period. Finally, manufacturing exports fell 12 per cent between 2000 and 2002 and remained in 2003 about 10 per cent below their level in 2000, thus accounting for more than 100 per cent of the fall-off of total goods and services exports in these years. Manufacturing sector net exports—exports minus imports--accounted for the entirety of the decline in US net exports during this interval. In sum, by way of its powerful restraining effect on the growth of consumer, investment, net export and, thereby, aggregate demand, the crisis of manufacturing was the fundamental factor—and a powerful one--depressing the economy from the time the slowdown began in the second part of 2000 through 2003, if not beyond.

Housing Price Run-up Drives the Upturn

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Between mid-2000 and mid-2001, GDP growth fell from 5 per cent to minus 1 per cent per annum and investment from 9 per cent to minus 5 per cent per annum -- faster than in any other twelve month period since 1945. The economy had entered a tailspin. To stem the plunge, the Federal Reserve, beginning in January 2001, lowered the cost of borrowing with unprecedented rapidity, reducing short-term interest rates on eleven occasions, from 6.5 per cent to 1.75 per cent, over the course of the year…and then a further total of 0.75 per cent in November 2002 and June 2003. Nevertheless, as the Fed soon discovered, interest-rate reductions are much more effective in reviving an economy in which the immediate source of recession is a fall in consumption resulting from the tightening of credit – as in all previous post-war cyclical downturns – than in re-starting an economy driven into recession by declining investment and employment resulting from industrial over-capacity. Vastly over-supplied with plant equipment, and software, non-financial corporations had little incentive to step up capital accumulation, let alone to increase borrowing to make that possible, no matter how far interest rates came down. The Fed was pushing on the proverbial string. Having risen sharply to help power the boom, average annual borrowing by non-financial corporations as a per cent of GDP dropped precipitously, from just under 4 per cent between 1996 and 2000 to just over 1 per cent between 2000 and 2004. Even in 2004, moreover, real non-residential investment had failed to come back to its level of 2000.

Failing to elicit borrowing and investment from corporations already weighed down by debt and recently purchased plant, equipment, and software, the Fed was obliged to rely on households and their consumption to drive the recovery. To make this possible in the face of declining employment and the slowed growth of real wages was, however, no easy task. Between 2000 and 2004, total real compensation for the workforce as a whole, including those working for the government, increased at an average annual rate of just 0.6 per cent per year (rising to 3 per cent in 2004), clearly insufficient to drive the economy, especially in view of the fact that the total contribution of both non-residential investment and net exports in this interval to real GDP growth was *less than zero.* The Fed was therefore obliged to fall back on its strategy of the 1990s – of seeking to enable spending by amplifying the wealth effect. But, given the collapse of the stock market in 2000-2001, it could not rely, as it did during the previous decade, upon the wealth effect of pumped up equity prices. It therefore sought instead to push down mortgage rates so as force up the value of residences and in that way to facilitate stepped up household borrowing reduced household saving and, in that way, jacked up personal consumption. Thanks in large part to the Fed's actions, long-term borrowing costs did fall significantly and housing prices rose precipitously. Between June 2000 and June 2003, the interest rate on 30 year fixed mortgages fell from 8.29 per cent to 5.23 per cent, a total of 37 per cent. Meanwhile, between 2000 and 2004, housing prices rose, in *real terms* (adjusted by the consumer price index) at the truly astounding average annual rate of 6.3 per cent, compared to minus 0.6 per cent between 1990 and 1994 (which also encompassed a recession year plus three years of recovery) and just 2.7 per cent in the boom years of 1995-2000. Together, the decline in the cost of borrowing and the explosion of housing prices laid the basis for the cyclical upturn.

While the Fed implemented its stimulus by way of the wealth effect of rising real estate values, the Bush administration added what had the appearance of a major fiscal stimulus modeled after that of Ronald Reagan, forcing through Congress enormous cuts in taxation and major increases in military spending. But these measures were less potent than they appeared. Since most of the reduction in taxation was accounted for by the decrease in the levy on dividends, it benefited the very rich almost exclusively. Its effect was therefore much more to increase savings and the purchase of financial assets than to boost consumption, or aggregate demand. Moreover, the fact that tax cuts at the federal level had the effect of reducing revenue to money-strapped state governments, forcing them to cut back on spending and in some cases to increase taxation, counteracted much, though not all, of what stimulus they did impart. Military spending amounted to more than three quarters of the increase in federal expenditures between 2000 and 2004, and did help the economy stay afloat. But

the fact remains that it accounted for just 1 percent in total GDP increase during the four-year period. In view of the recession, Keynesian policies were no doubt in order, and the Bush administration's spending increases and revenue reductions did bring about a gigantic shift from a hefty federal budget surplus of 3 per cent of GDP in 2000 to a major federal budget deficit of 3.2 per cent of GDP in 2004. But, because they were aimed much more at the achievement of particular political goals than providing a stimulus—namely at building up the military and redistributing income to the rich from everyone else--they proved only minimally effective in aiding the economy's revival.

It was by taking advantage of the record setting appreciation in the value of their homes, and the parallel fall in borrowing costs, that households were able to play their assigned role--driving the economy by stepping up their spending. They used their housing wealth to derive huge sums from their housing equity and on that basis were able to accelerate their personal consumption. Between 2000 and 2004, household borrowing as a percentage of personal disposable income grew as never before, reaching the unheard of level 11.8 per cent. This was more than double its level as recently 2000, and almost 20 per cent higher than the previous record, set in 1985. On this foundation, real personal consumption expenditures increased at an average annual rate of 3.25 per cent and, in growth accounting terms, explained more than 100 per cent of the rise in GDP that took place in those four years.

Thanks to the huge subsidy to consumption that derived from sharply declining interest rates and the wealth effect of rising residential real estate prices, along with the failure of the dollar to fall very much, the US economy ended up following a paradoxical two-track trajectory, which had its origins in the second half of the 1990s.. Manufacturing and related industries experienced a profound contraction, which originated with the fall in manufacturing profitability between 1997 and 2001. But those sectors able to cater to the continuing rise of debt-driven consumer spending or to take advantage of falling costs of borrowing and rising wealth in the form of real estate did increasingly well, imparting a distinctive cast to US economic growth in the new millennium. Benefiting from an unprecedented rise in the demand for homes, the construction industry, starting in the early-mid 1990s, enjoyed a record-breaking decade-long boom, its rate of profit smashing all previous records for the industry. Meanwhile, directly fueled by the historic consumer spending spree, retailers also did spectacularly well, their profits further swelled by the extraordinary rise of imports from China, facilitated by the high dollar. The hotel and accommodations industry followed a similar trajectory. Finally, the increasingly corporatized health services sector registered what has came to look like permanent growth, its profits quintupling between the end of the 1980s and beginning of the 2000s. It has been these industries, plus finance along with real estate, that have been mainly responsible for the growth of employment and output in the real economy throughout the recovery, in the face of the default of manufacturing,.

The rise of the financial sector had of course already assumed revolutionary proportions and transformed the map of the American economy over the course of the 1990s. Amazingly, the bursting of the equity price bubble and ensuing growth slowdown failed to hold it back. The red-hot housing market replaced the red-hot equity market as a generator of business, and low short-term costs of borrowing, insured by Fed, did the rest. By piling up profits in mortgage-related business, as well as in bond trading and underwriting, banks and securities firms were thus able to prosper, even in the face of the huge decline in corporate borrowing. At the same time, with the Fed effectively *guaranteeing* for an extended period that it would not raise interest rates, financial institutions could not help but make record-breaking profits with relatively small risk, simply by borrowing short cheap and lending long dear. Between 2000 and 2003, financial sector profits came to constitute, according to Morgan Stanley, some 50 per cent of total corporate profits, accounting for an astounding 80 per cent of the increase in corporate profits that realized in that period.

A Self-Limiting Trajectory

The Fed's turn to ever easier credit brought a semblance of order to the economy, though conspicuously only outside of manufacturing, as the manufacturing sector continued to sputter. But it did so, in large part, by means of -- and at the cost of -- inflating financial asset bubbles and inviting economic imbalances that threatened its capacity to sustain itself.

What ultimately made possible the cyclical upturn that began in November 2001 was the ability of the wealth effect of the housing price run-up to take over from that of the equity price bubble in driving the growth of demand from the point at which the stock market began to fall, in 1999-2000. In a crucial sense the economy has therefore been following the same asset-price, wealth-rather-than-income-driven trajectory for close to a decade. As shareholders accumulated wealth via the stock market boom of the second half of the 1990s, they were able to demand more expensive houses faster than the latter could be supplied, detonating the run-up of real estate values. As house prices rose, homeowners became willing to pay ever increasing sums for real estate, on the assumption that values would continue upwards, as they were doing in the stock market. When the stock market crashed and the boom came to an end in 2000, not just the Fed's record interest-rate reductions, but also a major transfer of funds from the equity to the housing market, kept the game going. As with the stock market run up, the real estate bubble has fed on itself, and increasingly so, with increased borrowing facilitated by rising paper wealth and easy credit making for greater housing demand and still higher real estate values, which provide the collateral for still more borrowing making for more demand and higher housing prices, and so on.

Between 1995 and 1999, as household wealth (on an annualized basis) in the form of equities (including mutual funds) rocketed from 5.3 to 12.05 trillion dollars, household wealth in the form of real estate also rose briskly, though more modestly, from 8 trillion to 12.5 trillion dollars. But as household equity values fell back between 1999 and 2002 to 7.3 trillion dollars, household real estate continued to rise in value to 13.7 trillion dollars, going a significant distance to compensate for the stock market decline. Over the next two years, household residential wealth exploded upwards, increasing by more than 30 per cent to 18.6 trillion dollars in 2004, dwarfing household equity wealth at just 11 trillion dollars. The rise in household real estate values surpassed 50 per cent in just the four years between 2000 and 2004.

On the basis of this huge on-paper appreciation of the value of their residences, households were able to extract dramatically increased funds from their home equity by selling their homes at prices surpassing their mortgage debt, buying new ones, and still having case left over; by refinancing and increasing the size of their existing mortgages, extracting cash in the process; and by taking out new home equity loans either in the form of lines of credit or second mortgages. If one adds these three sources of money together, households were able to raise, by way of equity withdrawals, the astounding sums of 317, 452, 528, and 640 billion dollars in 2001, 2002, 2003, and 2004, respectively. According to the Federal Reserve, households are using roughly fifty per cent of their housing equity withdrawals to finance consumer expenditures. This means that, between 2000 and 2004, housing equity cashouts accounted for an astounding 950 billion dollars in increased personal consumption expenditures. This was almost three times the increase in the total compensation for the labor force in this interval, at 368 billion dollars, and, amazingly, accounted for about two-thirds of the total increase of 1.490 trillion dollars in personal consumption expenditures. All told, housing accounted for about one third of GDP growth between 2000 and 2004, which means that, by virtue of its contribution, the average annual growth of GDP, which would without it have been 1.7 per cent, reached 2.5 per cent.

Yet, it is hard to see how cashing out on anything like the scale of 2001 through 2004 can long continue. This is because real estate price inflation seems bound to lose speed, while interest

rates, which fell near post-war lows in 2003, seem more likely to rise than fall (unless the economy were to stagger). Even if interest rates merely stay the same, they will likely suck some of the air out of the wealth effect of the housing market, because, in that circumstance, households are less likely to pursue cash out re-financing. Homeowners' propensity to borrow also seems likely to decline, as the equity held by households in their homes has fallen sharply as a percentage of those homes' value, while their debt as a percentage of income has reached record highs. But if household borrowing were to slow, the growth of consumer spending would be hit, and thereby a main prop to the recovery right through 2004.

By pumping up the wealth effect of rising home values, the Fed not only jacked up consumer spending so as to enable US GDP to keep growing, but also, by way of that rising consumer spending, made it possible for US imports to continue rise, and thereby helped coax the world economy from recession.. At the same time, however, most of the rest of the world was unable or unwilling to turn to the growth of debt in as extravagant a fashion as the US and had, in addition, a lower propensity to import than did the US, especially as a result of the pervasive turn to austerity and export dependence over the previous two decades. As a consequence, US exports declined sharply when the rest of the world entered the cyclical downturn with its powerful hit to purchasing power. The outcome was that, in 2004, the US current account deficit set still another record – as it had in 2002 and 2003 – rising to a 6.5 per cent of GDP. Ever-expanding US external deficits thus contributed mightily to keeping the world economy turning over through recession and cyclical upturn, just as they had between 1980 and 1985 and again between 1995 and 2000, which . As in those periods, overseas manufacturers exploited an overvalued dollars, as well as debt-subsidized US purchasing power, to take an increasing share of the US market at the expense of US producers so as to drive their own manufacturing-dependent economies forward, while undermining US industry. In fact, the rise of the US manufacturing trade deficit accounted for almost the entire epoch-making increase of the US current account deficit between 1980 and the present. Since 2000, this trend has reached something of a climax, playing a major part in the crisis of US manufacturing and the weak and distorted character of the US cyclical recovery.

The rise of the US current account deficit has itself depended on the willingness of the rest of the world to finance it. During the second half of the 1990s, mesmerized by the New Economy's bubble-driven boom, they were more than happy to do so, making huge direct investments in the US and buying up enormous quantities of corporate equities and bonds in expectation of endless profits. In so doing, they amplified the asset price bubble and its resulting wealth effect, while keeping the dollar rising, and in that way enabled their own countries' exports to the US to continue to increase and their own economies to continue to grow. But as the stock market crashed and the US economy slowed, private investors in the rest of the world found US assets decreasingly attractive, especially stocks and direct investment. **Whereas in the years 1999, 2000, and 2001, average annual purchases of equities and direct investments in the US totaled and respectively, the analogous figures for 2002, 2003, and 2004 were and** In fact, during 2003 and 2004, US purchases of the rest of the world's equities and US foreign direct investment out ran the rest of the world's purchases of US assets and their US direct investment, a telling indication of just how difficult it has become to elicit the interest of private overseas investors in key section of the the US economy. As the current account deficit has risen ever higher, downward pressure on the dollar has therefore become ever strong, with the result that the currency fell by more than 40 per cent against the euro between the end of 2001 and the end of 2004. Were the dollar to continue to decline, the Federal Reserve could be faced with an excruciating choice: either let the currency drop and invite a wholesale liquidation of US properties by foreign investors, which would risk an asset price crash, or raise interest rates, and possible set off a new recession.

In fact, through the end of 2004, the decline in the dollar's exchange rate overall was less

than 15 per cent, because it took place almost entirely in terms of the euro and to only a small extent in terms of the currencies of East Asia. This was the case, even though trade with East Asia was heavily responsible for the growth of US trade and current account deficits. The dollar held up against East Asian currencies for the straightforward reason that East Asian governments, led by Japan and China, in order to sustain their countries' exports to the US, entered the currency markets so as to prevent the dollar value of their currencies from rising and devoted an overwhelming proportion of their mounting reserves to the purchase of dollar denominated assets. Since the demand of private investors for US assets could no longer finance the US current deficit and thereby keep the exchange rate of the dollar up, asset prices rising, and US consumption ascending, East Asian governments had to fill the gap if they wished the US market to continue to drive their export oriented economies. In 2003 East Asian governments increased their dollar reserves by 485 billion dollars and in that way covered no less than 90 per cent of the 530 billion dollar US current account deficit. In 2004, they acquired another 465 billion dollars in dollar reserves and thereby financed roughly 75 per cent of the US's $670 billion dollar current account deficit. It was through these purchases that the East Asian central banks paved the way for the US economy to absorb a near 30 per cent increase in imports from Asia in those two years.[1]

The huge acquisitions of dollar denominated assets by East Asian central banks not only prevented the US dollar from falling, but kept the US recovery on track, by covering the great bulk of the Bush administration's growing Federal deficit. Between 2000 and 2004, as the US federal budge balance fell from a 3 per cent of GDP in surplus to 3.2 percent of GDP in deficit, overall holding of US Treasury Bonds increased by about 960 billion dollars. Nevertheless, private parties in the US not only failed to make *any* net purchases of the Treasuries put on sale, but actually slightly *reduced* their Treasury holdings in this period. As buying by the Federal Reserve and state and local governments accounted for a bit less than one third of the increase in Treasury holdings, acquisitions by the rest of the world turned out to be responsible for more than two-thirds, and East Asian central banks were responsible for the great bulk of these. Their enormous subsidy to total demand for Treasuries held down interest rates--by somewhere between one per cent and two per cent—and in this way enabled the housing market to continue to explode upward and US households to play their assigned part in driving consumption. By closing the financing gap that would otherwise have resulted, East Asian central banks enabled the Fed and the administration to pursue hyper-expansionary policies to stoke a recovery that would, in their absence, have, almost certainly, come to grief due to rising costs of borrowing and a declining currency leading to declining asset prices. But, of course, the more they did so, the longer the dollar stayed high, the larger were US manufacturing imports, the greater was the harm to the US manufacturing sector, and the more the US current account deficit rose…requiring an ever greater accumulation on the part of the East Asians. This is a process that would seem, on its face, to have a short half life. It requires East Asian central banks to accept ever greater losses by way of the devaluation of their reserves when the dollar is finally allowed to fall and to contemplate ever greater internal inflation as they inject money in the economy to buy up the dollar surpluses of local exports. It requires the US economy to pursue its expansion even as its manufacturing sector is subjected to ever greater pressure from subsidized producers from abroad.

A Weak and Hesitant Expansion

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But fact remains, despite the huge exogenous boost to demand, the cyclical , recovery remains problematic, its future uncertain. The economic stimulus unleashed by US governmental authorities and buttressed by the East Asian central banks between the start of 2001 and the present--featuring record interest rate reductions and historic federal deficits, buttressed by a major devaluation of the dollar—has been the greatest in US history. Still, in 2001, 2002, and 2003, the economy struggled, increasing at an average annual rate of just 1.9 per cent, even despite an enormous lift in 2003 from

the Bush administration's tax rebate and a sharp rise in military spending resulting from the Iraq War. In 2004, GDP growth did jump to 4.4 per cent. Even so, in 2004, the level of real non-residential investment had still failed to return to its level in 2000, net exports (i.e. the trade deficit) was in the negative a further 60 per cent, and money derived from housing equity withdrawals that was devoted to personal consumption was just about as high as total compensation and 68 per cent of personal consumption expenditures. Above all, the jobs recovery was by far the worst of the postwar epoch, with employment rising a scant 1.1 per cent in the three years of cyclical upturn following the cyclical trough of November 2001, compared to an average of 8.3 per cent for the same interval in previous post-war business cycles. As a result, total real compensation increased just 7.4 per cent in the same period, compared to the post-war average of 16.6 per cent. With the growth of demand so far below normal and so far short of what was needed, the pressing issue of the day was whether the corporate sector would indeed generate sufficient investment and jobs growth soon enough to keep the economy growing as the government's stimulus petered out, as the Fed had been counting on since the recession of 2001. By the middle of 2005, this question was imposing itself with ever more urgency as long term interest rates had begun to fall, indicating increasing slack in the economy in the middle of the recovery. .

The necessary, if not sufficient, condition for the sustained growth of expenditures on new plant, equipment, and software and on new hiring is a dramatic and sustained increase in profitability – the critical missing factor in the expansion of the previous decade after 1995. . The average rate of profit for the business cycle of the 1990s did not rise palpably above the levels of those of the 1970s and 1980s, remaining about 15 per cent below the average for the postwar boom (1948-1969), and proved insufficient to underpin a decisive break from the long downturn. For the economy to sustain a new boom by way of lasting increases in investment, employment, output the impressive ascent of profitability that began in the mid 1980s--but came to grief after the mid-1990s--must therefore, in effect, take up where it left off, and go a good deal higher.

In fact, from the end of the recession in November 2001, the profitability recovery was at first slow, but accelerated in 2003 and, especially, 2004. Nevertheless, because it had to take place in the face of the continued downward pressure on profits in manufacturing and because came from such a depressed level, it still had good distance to go and could well face increasing difficulty in continuing its ascent. After having fallen by 34 per cent between 1997 and 2001, the manufacturing rate of profit was still, two years later in 2003, 28 per cent below its 1997 level. This meant recovery was having to proceed mainly outside manufacturing. Meanwhile, After having declined by about 10 per cent between 1997 and 2000 as the boom reached its apex, the rate of profit in the non-financial corporate sector plunged a further 21.3 per cent in the recession of 2001, or a total of 28 per cent between 1997 and 2001, to *its lowest level since 1945* (with the single exception of 1980). In 2004, the non-financial corporate profit rate had come back to its level of 2000. But that still left it at about the average for the whole of the 1990s business cycle. The failure of the profit rate to sufficiently ascend was almost certainly a fundamental factor in accounting for the economy's weak response to the government's titanic stimulus program and the precariousness of the recovery right through 2004.

It is a real question, moreover, whether the revival of profitability can be sustained. With output and investment growth muted through much of the cyclical upturn, corporations sought to restore their profit rates primarily by means of raising productivity and holding down wages. In fact, between 2000 and 2004, including the recession year 2001, the growth of real output per hour in the nonfarm economy averaged 3.6 per cent, compared to just 2.5 per cent between 1995 and 2000, the years of the "economic miracle." As a consequence, some leading economic analysts, not to mention Alan Greenspan, have already been asserting that the miracle of productivity growth that never quite materialized in the 1990s is now upon us, with New Economy technology being

implemented more speedily and effectively than hitherto. By implication, a path to profitability revival and economic dynamism has been opened up.

But such a deduction is premature, to say the least. Its Achilles heel is obvious: so far, increases in output per hour have taken place in the face of a sharp *reduction* in investment growth, i.e. the slower introduction of more and better plant, equipment and software, compared to that of the 1990s expansion. Is it really believable that technological advance speeded up so discontinuously and so rapidly as to yield a rate of productivity growth between 2000 and 2004 that was 60 per cent higher than between 1995 and 2000, despite the fact that the growth of real capital stock in this interval was about half as fast during the second half of the 1990s? The more plausible explanation is that the recorded gains in productivity largely represent not so much increased efficiency – meaning more output from the same labor input – as more output from more labor input per hour – i.e. speed-up. It is telling in this respect that, between 2000 and 2003, the manufacturing sector secured a spectacular average annual rate of productivity growth of 6.9 without increasing its capital stock *at all* and reducing hours worked at an average annual pace of 6.2 per cent.

As speed up was making possible a big jump in productivity growth, corporations were taking the fruits of the increase in GDP to an extent probably unprecedented in US history. During the first three years of the cyclical upturn, between November 2000 and November 2004, net profits in the non-financial corporate sector rose a cool 71 per cent, while compensation increased just 13.6 per cent. Put another way, increased profits accounted for an astounding 43.5 per cent of the total increase in net value added during this interval. On this basis, the net profit share (adjusted for indirect business taxes) leaped up by an unheard of 50 per cent, from 12.8 per cent to 18.1 per cent, in just those three years.

The increase in profitability achieved during the cyclical upturn has thus been driven, probably to the greatest extent in US history, simply by means of the increase in exploitation—i.e. the intensification of labor plus a shift in income distribution to capital from labor. Because increased profits were extracted with relatively little recourse to increases in either labor or capital stock, they translated more or less directly into increases in the profit rate. Yet, one is entitled to ask whether corporations can go much further than they already have in improving their profit rates by extracting still more labor inputs per hour for relatively less pay from their employees, especially if the rate of GDP growth is sustained. But, to the extent that they must, in future, rely on the more rapid increase of employment and of plant, equipment, and software, productivity growth will decelerate, wage growth will accelerate, and profitability increase will slow. As the cyclical recovery lengthens, the ride toward higher profit rates is likely to become much bumpier…yet it will also become more necessary, as the exogenous stimuli that have driven the expansion dry up. .

Conclusion

The potential for the recovery of profitability and, in turn, of investment and employment growth, must ultimately be evaluated in terms of the economy's trajectory since the recession of 2000-2001, determined to such a very great extent by the character of the Fed's intervention. As repeatedly stressed, it has been the growth of mainly household debt--dependent on the wealth effect of rising residential real estate values, itself reliant upon the persistently low cost of long term borrowing, ultimately confirmed by the East Asians as the byproduct their pursuit of a high dollar--that has been largely responsible for driving the cyclical expansion. This remedy was initially prescribed to respond to the collapse of investment and consumer demand, as well as a broad range of equity values, in 2000-2001 that resulted from the plunge of manufacturing profitability between 1997 and 2001. But the basic difficulty with it is that, far from confronting the problem that lay behind the failure of the New Economy and the subsequent cyclical downturn—viz. over-capacity

manufacturing making for reduced profitability in the international economy and its US component--it has only exacerbated it.

The high dollar in combination with cheap credit, ultimately assured by Asian central banks, thus makes for persistently inflated US costs of production and depressed profitability in industries exposed to the world market, above all manufacturing. Repressed rates of return in tradeables encourage US business not only to persist in their refusal to hire or lay down much new plant and equipment, but also to seek to re-locate increasing proportions of their production abroad in order to export back home…and, advantaged as it is by easy access to loans and an inflated currency, to step up their purchase of foreign companies and equities, or, indeed, financial assets, such as real estate. The overall effect of course is to further weaken US manufacturing, which as recently as 1997 was offering a rate of profit that was more than double that which could be secured in the non-financial non-manufacturing sector and which, for that reason, was accounting for a highly disproportionate share of total corporate profits. As the opposite side of the coin, the persistently high dollar and record-breaking US borrowing have propelled the spectacular expansion of East Asian manufacturing. Schematically speaking, Japan, Taiwan, and Korea sell China capital and intermediate goods, which it combines with its cheap and increasingly skilled labor force, in order to work up products to export to the US market. But since Chinese, and much of East Asian manufacturing, is to a large extent about underselling goods already produced by US manufacturers and thereby appropriating their markets, assisted by the high dollar, East Asian production tends not so much to complement, but to replicate, already existing manufacturing production, and thereby to exacerbate over-capacity on a global scale. This is made that much worse by the way in which East Asian production, and international over-capacity, are swelled by increased US household indebtedness leading to rising US imports. Meanwhile, of course, the continuing influx of East Asian funds onto US financial markets, by pushing down the cost of borrowing, tends, directly or indirectly, to fuel the further expansion of financial bubbles in real estate, as well as in US Treasury and agency bonds. The resulting wealth effect makes for ever greater current account deficits, and calls forth further Asian financing to close the circle.

This syndrome—featuring expanding asset bubbles on the one hand and downward pressure on manufacturing profits on the other--is, of course, pretty much the same one that has plagued the world economy and its US component throughout the New Economy boom and the hesitant cyclical upturn that has followed. It is a self-undermining path in which the inexorable increase of US obligations to the rest of the world allows the rest of the world to grow through exports at the expense of US productive power…and of the capacity of the US to honor those obligations. It is a process that has, moreover, already led to an asset-market crash, a massive crisis of the US manufacturing sector, and a serious recession…and, if it is enabled to continue, it is likely to bring about an analogous, if not worse, outcome.

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[1] These figures are significantly higher than those to be found in US sources. The latter understate central banks' buying of treasuries , because much of this is accounted for by private parties acting for the central banks. The actual increases in central banks' dollar denominated reserves can be accurately determined, because they are reported annually by them to the Bank of International Settlements. See N. Roubini and B. Setser, "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of Hard landing in 2005-2006", New York University, unpublished manuscript, 2005, p.1, available at Roubini Global Macro Web Site. Cf. M. Higgins and T. Klitgaard, "Reserve Accumulation: Implications for Global Capital Flows and Financial Markets," *Current Issues in Economics and Finance*, vol. x, no. 10, Federal Reserve Bank of New York, September-October 2004

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