IS THE U.S. ECONOMY HEADED FOR A HARD LANDING?

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In the first thirty years after World War II, the United States economy performed remarkably well. The rate of growth averaged 4-5% a year, the rate of unemployment was seldom above 5%, inflation was almost non-existent (1-2% a year), and the living standards of workers improved substantially (the average real wage, or the purchasing power of wages, roughly doubled over this period). This was the "golden age" of US capitalism.

However, this "golden age" ended in the 1970s. Since then, the rate of growth has been slower (has averaged 2-3% a year), the rate of unemployment and the rate of inflation have both been higher, and, most strikingly, the average real wage has hardly increased at all. It is in this sense that we refer to the "stagnation" of the US economy in recent decades.

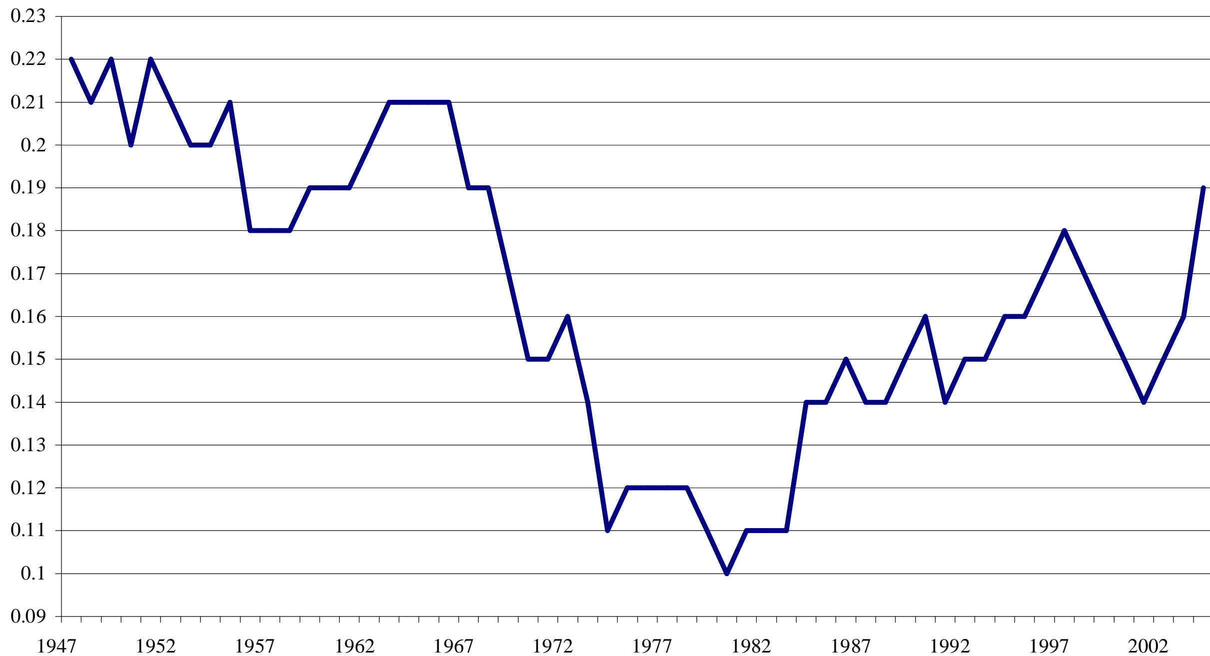
During the late 1990s, the US economy improved significantly, with the highest rates of growth (3-4%), the lowest rates of unemployment and inflation since the 1960s, and real wages increased modestly. As a result, most economists concluded that the late 90s "boom" marked the end of the long period of stagnation and the beginning of a new prolonged period of sustained prosperity, similar to the early postwar "golden age". However, this "boom" came to an end in 2001, and the US economy fell again into recession. The recovery since 2002 has been slow and disappointing, and job growth has lagged behind previous recoveries. It has been called a "jobless recovery". This paper presents a Marxian explanation of the long period of stagnation in the US economy, and will attempt to determine whether or not this period of stagnation is indeed over, or whether the US (and world) economy is perhaps headed for something even worse.

1. The decline of the rate of profit

I argue, based on Marxian theory, that the most important cause of the long period of stagnation in the US economy was a very significant decline in the rate of profit (the ratio of total profit to the total capital invested) for the economy as a whole.[1] From 1950 to the mid-1970s, the rate of profit in the US economy declined almost 50%, from around 22% to around 12% (see Figure 1; see Moseley 1992, Appendix B, for a description of the sources and methods used to derive these estimates.) This significant decline in the rate of profit appears to have been part of a general world-wide trend during this period, affecting all capitalist economies.

1. Total profit includes the interest paid to creditors, and hence is a comprehensive measure of the total "return to capital" for capital as a whole, including both non-financial and financial capital.

FIGURE 1: THE RATE OF PROFIT IN THE POSTWAR U.S. ECONOMY



Data Figure 1

According to Marxian theory, this very significant decline in the rate of profit was the main cause of both of the "twin evils" of higher unemployment and higher inflation, and hence also of the lower real wages, of recent decades. As in periods of depression of the past, the decline in the rate of profit reduced business investment, which in turn has resulted in slower growth and higher rates of unemployment. One important new factor in the postwar period is that many governments in the 1970s responded to the higher unemployment by adopting expansionary fiscal and monetary policies (more government spending, lower taxes, and lower interest rates) in attempts to reduce unemployment. However, these government policies to reduce unemployment generally resulted in higher rates of inflation, as capitalist firms responded to the government stimulation of demand by raising their prices at a faster rate in order to restore the rate of profit, rather than by increasing output and employment.

In the 1980s, financial capitalists revolted against these higher rates of inflation, and generally forced governments to adopt restrictive policies, especially tight monetary policy (higher interest rates). The result was less inflation, but also higher unemployment. Therefore, government policies have affected the particular combination of unemployment and inflation at a particular time, but the fundamental cause of both of these "twin evils" has been the decline in the rate of profit.

2. Attempts to increase the rate of profit

Capitalists have responded to the decline in the rate of profit by attempting to restore the rate of profit in a number of ways. The last three decades in the US economy have been characterized above all else by attempts by capitalists to increase the rate of profit back up to its earlier higher levels.

I have already mentioned the strategy of **inflation**, i.e. of increasing prices at a faster rate, which reduced real wages, or at least avoided increases in real wages, so that all the benefits of increasing productivity in recent decades has gone to higher profits. More recently, more and more companies are actually **reducing money**

wages, for the first time in the US economy since the Great Depression. Many Workers have been faced with the choice of either accepting lower wages or losing their jobs.

Another widespread strategy has been to **cut back on health insurance and retirement pension benefits**. Workers are having to pay higher and higher premiums for health insurance, and many workers who thought that they would have a comfortable retirement are receiving a rude awakening, and probably will have to work until an older age, leaving fewer jobs for younger workers. The *New York Times Magazine* of October 30 had a feature article entitled "The End of Pensions".

Another very common strategy to increase the rate of profit has been to make workers work harder and faster on the job; in other words: "**speed-up**". Such a "speed-up" in the intensity of labor increases the value produced by workers and therefore increases profit and the rate of profit. The higher unemployment of this period contributed to this "speed-up", as workers have been forced to compete with each other for the fewer jobs available by working harder. One common business strategy has been "down-sizing", i.e. layoff 10-20% of a firm's employees and then require the remaining workers to do the work of the laid-off workers. This method also generally increases the intensity of labor even before the workers are laid off, as all workers work harder so that they will not be among those who are laid off.

A more recent strategy has been to use **bankruptcy** as a way to cut wages and benefits drastically. Companies declare "Chapter 11" bankruptcy, which allows them to continue to operate, and to renegotiate their debts, and most importantly to declare their union contracts null and void. This strategy was pioneered by the steel industry in the 1990s, and has spread to the airlines industry in recent years. Half of the airline companies in the US are currently in Chapter 11 bankruptcy, and they are making very steep cuts in wages and benefits (25% or more).

The most recent example of this drastic strategy is Delphi Auto Parts, the largest auto parts manufacturer in the US, which was owned by General Motors until 1999. Delphi declared Chapter 11 bankruptcy in early October, and announced that it is cutting wages by approximately **two-thirds** (from an roughly $30 per hour to roughly $10 per hour), and is reducing benefits correspondingly. The Delphi chief executive (who used to work in the steel industry) has publically urged the automobile companies to follow the same strategy. This strategy could spread to the unionized companies in the rest of the manufacturing sector of the economy in the years ahead

Therefore, we can see that the strategies of capitalist enterprises to increase their rate of profit in recent decades have in general caused great suffering for many workers - higher unemployment and higher inflation, lower living standards, and increased insecurity and stress and exhaustion on the job. Marx's "general law of capitalist accumulation" - that the accumulation of wealth by capitalists is accompanied by the accumulation of misery for workers - has been all too true in recent decades in the US economy (and of course in most of the rest of the world). Most American workers today work harder and longer for less pay and lower benefits than they did several decades ago. It appears to be the end of an era in which blue-collar workers in the US could be part of the middle class.

Another increasingly important strategy by capitalists to reduce wage costs has been to move their production operations to low-wage areas around the world. This has been the main driving force behind the so-called "**globalization**" of recent decades: *a world-wide search for lower wages in order to increase the rate of profit*. This is the essence of globalization. This strategy also puts more downward pressure on wages in the US, because of the much greater threat of "out-sourcing" jobs to other countries. NAFTA and CAFTA are of course very important parts of this overall globalization strategy.

It appears that this all-out campaign by capitalists to increase the rate of profit in all these ways has been fairly successful in achieving this objective. It has taken a long time, but the rate of profit is now approaching the previous peaks achieved in the 1960s, as we can see from Figure 1. The last several years especially, since the recession of 2001, has seen a very strong recovery of profits, as real wages have not increased at all, and productivity has increased very rapidly (4-5% a year). And these estimates do not include the profits of US

companies from their production abroad, but include only profits from domestic US production. If the profits from overseas production of US companies were added in, it would appear that the recovery of the rate of profit is pretty much complete.

As we have seen above, this recovery of the rate of profit of US companies has been accomplished at the expense of US workers. It has also been accomplished without a major depression in the US economy. I think this would have surprised Marx, who argued that just cutting wages by itself would in general not enough by itself to fully restore the rate of profit, and that what would usually be required in addition was a deep depression characterized by widespread bankruptcies that would result in a significant devaluation of capital. That has not yet happened in the US economy, and yet the rate of profit appears to be more or less fully restored. But I don't think Marx envisioned reducing wages by as much as 90% made possible by "globalization".

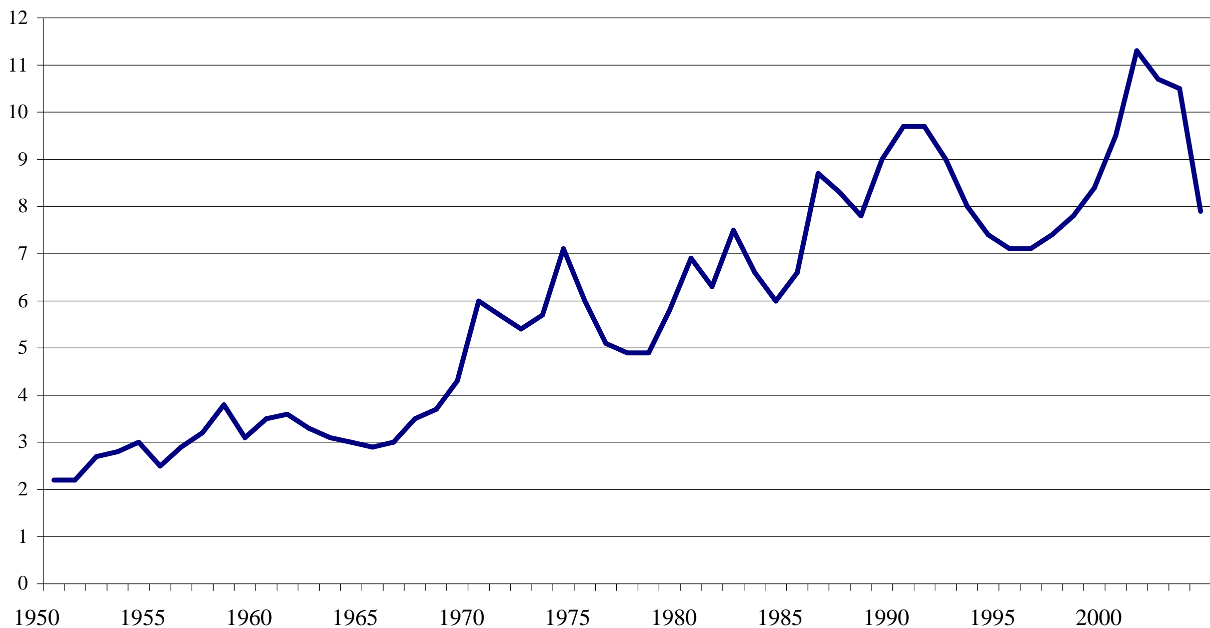
3. Unprecedented levels of debt

Even though the rate of profit has been largely restored, serious problems remain in the US economy, problems that have to do mainly with extremely high and historically unprecedented levels of debt of all kinds – business debt, household debt, and external foreign debt. An explosion of all these different kinds of debt has been the main source of growth in the US economy in recent decades. This debt has enabled businesses to continue to invest in spite of lower profits and households to continue to spend in spite of stagnant wages. However, now both businesses and especially households are faced with much higher debt levels and a much greater danger of defaults and bankruptcies in the months and years ahead. This explosion of debt cannot go on forever, with debt increasing much faster than income, and it makes the US economy much more vulnerable to a serious downturn in the future. I will briefly examine each of these kinds of debt in turn.

3.1. Business debt

The ratio of **debt to profit for nonfinancial corporate business** is shown in Figure 2. We can see that the current level of debt is about 4-5 times higher than it was in 1950 and about twice as high as it was in 1980. Furthermore, the bankruptcies in recent years of Enron and WorldCom and other companies have revealed that much business debt can be kept "off the books" by questionable accounting practices, which became increasingly prevalent in the 1990s. The decline in this ratio in the 1990s and in recent years was due in part to the increase of profits, but was also due to the increasing transfer of debt from the books of nonfinancial corporate businesses to "special purpose vehicles". Therefore, Figure 3 understates the actual debt burden of nonfinancial corporations, which will make them more vulnerable to defaults and bankruptcies in the years ahead. Furthermore, the debt to profit ratio is much higher in the manufacturing sector of the economy, especially in the airlines and the automobile industry. Both of these industries have suffered significant losses in recent years, and both industries also have very high debts. The bonds of these key companies in the US economy are now rated as high-risk "junk bonds".

FIGURE 2: RATIO OF DEBT TO PROFIT, NON-FINANCIAL CORPORATE BUSINESS, 1950-2003

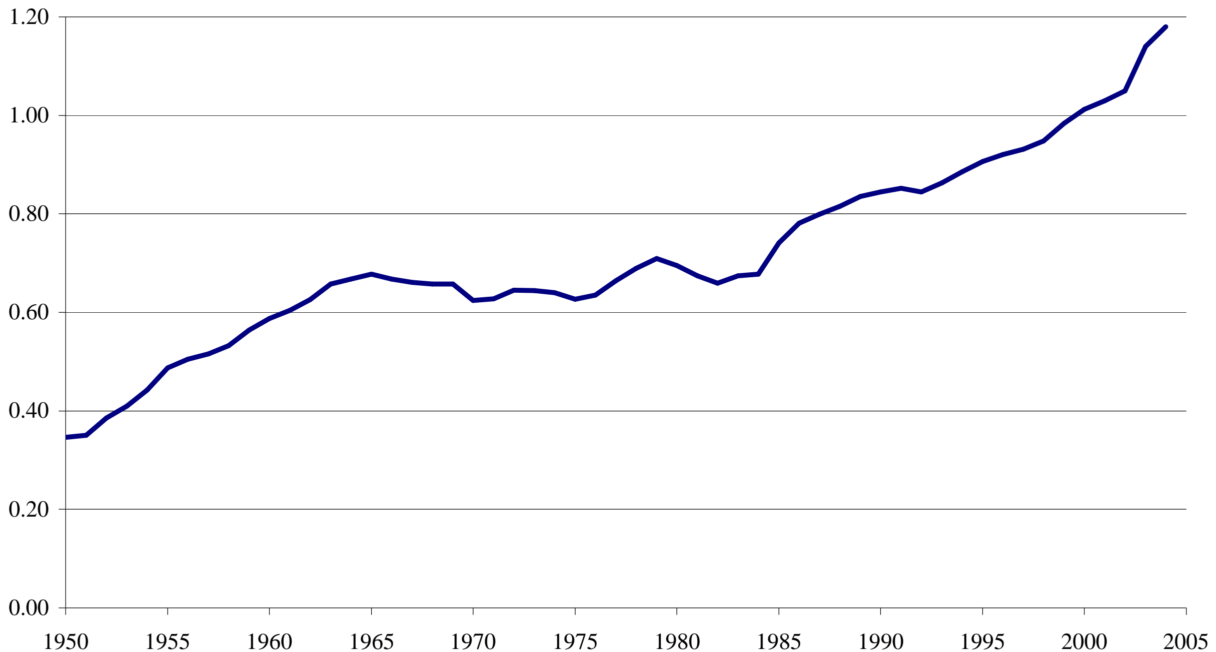


Data Figure 2

3.2 Household debt

Even more alarming is the ratio of **household debt to household disposable income**, which is shown in Figure 3. We can see that this ratio has approximately quadrupled since 1950, with most of the increase coming since 1980, and is now over 100% for the first time in US history, and has continued to increase rapidly in recent years. In other words, household debt has been increasing much more rapidly than household income. The rapid increase of household debt during the late 1990s made possible the extraordinary "spending spree" of US households during these years, which provided most of the growth of the US economy. And this rapid increase of debt and strong consumer spending has continued even during the recession in 2001 and the weak recovery, as companies which were desperate to sell their goods offered customers more and more credit-financing (e.g. the "zero percent" loans of the automobile companies). The recession would have been much worse without this debt-financed consumer spending. However, as a result of this "borrow and spend" spree, US households are now in much greater danger than ever before of defaults and bankruptcies. Delinquency rates and default rates have already increased to record highs in recent years, in spite of the lowest interest rates in 50 years. If interest rates increase in the months ahead, as they almost certainly will, then many more families will be forced into bankruptcy. And to make things worse, the US congress has recently passed a new consumer bankruptcy law which will be much tougher on individuals who declare bankruptcy (they will have to continue to pay off more of their debts for longer periods of time).

FIGURE 3: RATIO OF HOUSEHOLD DEBT TO DISPOSABLE INCOME, 1950-2004



Data Figure 3

Another important indicator of the household debt burden is the "**debt service ratio**" – which is the ratio of debt service payments to household income. This debt service ratio is now also at an all-time high of 13.6%. And this is with the lowest interest rates in 50 years. As interest rise in the months ahead, this debt service ratio will increase further to unprecedented levels and probably unsustainable levels. This average debt service ratio for all families together tells only part of the story. The debt service ratio for families with incomes of less than $50,000 is around 17%, and for families with income less than $20,000 this ratio is almost 20%. Furthermore, 20% of families with income less than $50,000 have debt service ratios of greater than 40%! – i.e. spending almost half of their incomes to pay off debts. These families can barely meet their debt obligations now, often borrowing from one source to pay off debts from another source. This group would be the first to be pushed into bankruptcy when interest rates rise.

Another important feature of this explosion of household debt is that the category of debt that has increased the fastest in recent years is **home mortgages**, as a result of 50-year low interest rates and also very aggressive lending by banks. Banks are now offering innovative "bubble-type" mortgages, which reduce monthly payments in the first few years, but then payments increase sharply after that, especially if interest rates rise. The most popular example of these new types of home mortgages is called "**interest only mortgages**", according to which no principle has to be paid for the first 3-5 years. Approximately 1/3 of all mortgages in the US in 2004 were of this "interest only" type (and over half in California), up from almost zero as recently as 2000. Another third of all morgages were "adjustable rate" mortgages, whose montly payments will increase when interest rates rise.

These high risk mortgages have enabled many families to buy homes who otherwise would not have been able to afford one, and has also financed many speculative purchases, which have certainly stimulated housing construction, which in turn has been a very important boost for the US economy in recent years, adding at least a percentage point or two to the overall growth rate. However, there will be a heave price to pay in future years,

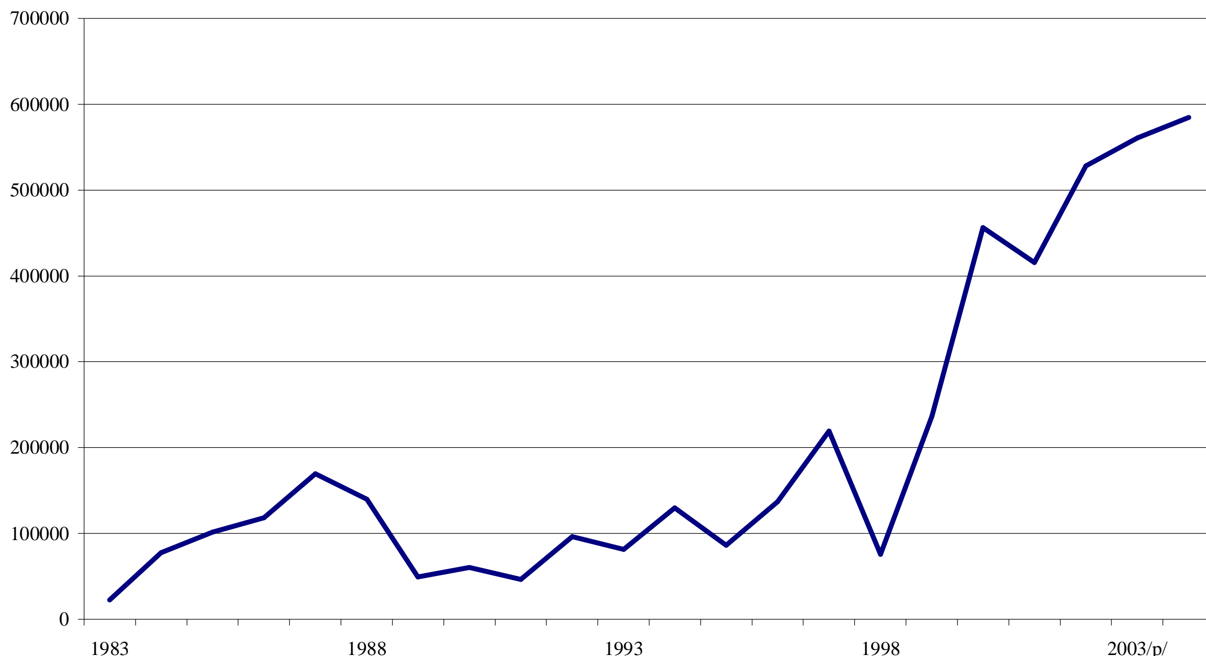
especially when interest rates rise. In the view of many economists, both heterodox and orthodox, this aggressive bank lending has resulted in a housing speculative bubble, which is very likely to burst within the next year or two. If that happens, then the US economy will almost certainly fall into recession.

Many families have also taken advantage of the very low interest rates of recent years to "**refinance**" their home mortgages, i.e. take out a new mortgage with a lower interest rate and pay off the old mortgage with a higher interest rate, thereby reducing monthly payments and leaving more disposable income available for consumer spending, and often borrowing more money (i.e. increasing the size of the mortgage) in the process, much of which is used to finance more consumer spending. Refinancing of this sort amounted to approximately $600 billion in 2004, which is almost 9% of consumer spending. But with interest rates rising, this source of borrowing more money is no longer available.

3.3. Foreign debt

Another very important aspect of this explosion of debt in the US economy is that much of the money borrowed by US businesses and households has come from foreign creditors . From the early 1980s (when the US became a "debtor nation" for the first time since before World War I) to 1994, the average annual net inflow of foreign capital was about $100 billion a year, for a total of almost $1 trillion over this period (see Figure 4). This increasing dependence on foreign capital by the richest nation in the world is unprecedented in world history, and is sharp contrast both to the US economy during the long post World War II boom and also to the UK economy in the 19th century, in which these leading nations were net creditors to the rest of the world, rather than net borrowers.

FIGURE 4: NET CAPITAL INFLOWS, 1983-2004



Data Figure 4

What is even more striking is the sharp increase in the inflow of foreign capital from 1995 to the present, which has increased to over $600 in 2004 and which has added to an additional $2.5 trillion worth of debt in these

ten years alone. This net capital inflow was equal to more than half of net private investment in the US during these years. And in 2004, the inflow of foreign capital was almost equal to total net private investment. It was also equal to about 1/3 of the total debt of all types incurred in the US economy in 2004 (in other words, this inflow of foreign capital has increased the amount of credit available in the US by 50%). This is a tremendous infusion of foreign capital, even by colossal US standards. Much has been said and written in recent decades about the foreign debt problem of developing countries around the world. The US foreign debt is now more than **twice** as great as the total foreign debt of all other countries of the world **combined**, and is increasing much more rapidly The richest country in the world is now absorbing approximately **80%** of the total net capital outflows from the rest of the world! This amounts to a global subsidy of about $2000 a year for each person in the United States, including children and babies; $8000 for a family of four. There is something perverse and obscene about the richest country in the world borrowing such huge amounts of money from the rest of the world in order to finance its consumption.

This huge inflow of foreign capital contributed significantly to the "boom" in the US economy in the late 1990s and to the recovery from the 2001 recession, in a number of ways: mainly by reducing interest rates, which in turn increased investment spending and also lowered the debt burdens of US corporations and households; also by keeping the dollar strong in spite of ever-increasing US current account deficits (also by increasing stock prices which stimulated consumer spending; and also by increasing government revenue and budget surpluses as a result of the faster growth). *Without this huge inflow of foreign capital, the US economic "boom" of the late 1990s would have happened and the recession of 2001 would have been much worse.* Of course, these beneficial effects for the US economy were counterbalanced by the opposite harmful effects on the countries which suffered an outflow of capital to the US.

Even more startling are the forecasts for the future, which suggest that this dependence on foreign capital is likely to **continue to increase** further in the years ahead. It looks like the current account deficit for 2005 will be around $800 (probably even more because of the recent oil price spike), which will require that roughly much capital inflow in order to keep the dollar stable and interest rates low.. And the forecasts for the current account deficit for 2006 are higher still, some as high as $1 **trillion** dollars. If so, then the global subsidy for the US would be $4000 per person per year, $16,000 per year for a family of four.

So the crucial question for the US economy in the months and years ahead is whether foreign creditors will continue to be willing to lend such extraordinary sums of money to the US year after year? In recent years, **private** capital inflows have stopped increasing, as private investors have become increasingly skittish about the likely prospects of a significant devaluation of the dollar. All of the increase of capital inflow since 2001 has come from foreign central banks, almost entirely Asian central banks, and especially **Japan** and **China**. The capital inflow from all central banks increased from $50 billion in 2001 to $185 billion in 2002, and to $486 billion in 2003 and $465 billion in 2004. In 2002 and 2003, Japan was the main lender, but since 2003, China has replaced Japan as the main lender, providing more that $200 billion in both 2004 and 2005. China and Japan are doing this of course in order to avoid an appreciation of their currencies and maintain their exports to the US. But unless private investors are willing to increase their lending (which does not seem likely), China and Japan and the other Asian countries will have to increase their lending even further. Will these countries continue to be willing to buy more and more dollar assets at this unprecedented rate, year after year, in spite of the fact that there is a near certainty that there will eventually be significant losses on these dollar assets, and that the longer they wait the greater the later losses will be? That is hard to imagine, but that is what will be required in order to keep the dollar stable and interest rates low in the US in the years ahead.

Private investors have maintained modest lending to the US in recent years on the assumption that the Asian central governments will continue to maintain the dollar peg. However, at the first sign that central bank financing will not be sufficient to stop a devaluation of the dollar, many of these private investors will begin to sell their dollar assets, thereby accelerating the decline in the dollar, and bringing on what very well could be a financial collapse in the US economy, and by extension, in the world economy. The risk of such a "dollar crisis"

is very high, and increases every day.

Such a "dollar crisis" would result in a **sharp increase in interest rates** in the US, both because of the Fed's preventative actions and also because of the necessity of offering higher interest rates in order to attract foreign investment. I hope it is clear from what I have said above about the unprecedented levels of business debt and household debt in the US economy today, that an increase of interest rates at the present time would be a disaster for the US economy, because it would force many highly indebted businesses and especially households into default and bankruptcy. The record levels of debt of recent years have been bearable because interest rates have been so low. But once interest rates increase, many of these debt burdens will become unbearable.

If such a dollar crisis were to occur, there would be very little the US government could do to stop it. Monetary policy would have to be more restrictive, not less, in order to stop the outflow of dollars. Fiscal policy is already very expansionary, as a result of Bush's tax cuts for the rich and his imperialist adventure in Iraq, which makes it very difficult to adopt even more expansionary fiscal policy to offset a crisis.

In sum, the US economy has been able to maintain a respectable rate of growth in the last three decades, in spite of lower rates of profit, because of the unprecedented explosion of debt for both capitalist firms and for households, much of which has been financed by an enormous, unprecedented inflow of foreign capital into the US. However, this increasing dependence of the US economy on foreign capital raises the very high risk that in the not-too-distant future, foreign central banks and foreign investors may no longer be willing to lend ever-increasing amounts of money to the US. If that happens, then the US economy would be in very serious trouble.

A comparison with 1929 is alarming. In 1929, there was very little household debt in the US economy. Business debt in relation to profit was about half as high as it is today. And of course there was no foreign debt - the US was a net **creditor** to the world in 1929. And yet the defaults and bankruptcies resulting from these lower levels of debt in 1929 were so bad that one-third the banks in the country failed, and the Great Depression lasted for more than a decade. What catastrophe would happen with the current much higher levels of debt, one can hardly even imagine.

If the US economy does go down, then it will take most of the rest of the rest of the world with it. The US has been the main "engine of growth" for the rest of the world in recent years, and if this engine stops, there appears to be no other engine to replace it. All this is frightening to think about, but I think there is a high probability that this is where the US and world economy are headed in the years ahead.

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