The US Economic Crisis:

From a Profitability Crisis to an Overindebtedness Crisis

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Abstract: This paper argues that the fundamental cause of the current economic crisis in the US economy was a significant long-term decline in the rate of profit from the 1950s to the 1970s. Capitalists responded to this profitability crisis by attempting to restore their rate of profit by a variety of strategies, including: wages and benefit cuts, inflation, "speed-up" on the job, and globalization. These strategies have largely restored the rate of profit, but have resulted in stagnant real wages for workers for decades. As a result, household indebtedness has increased to unprecedented levels and must be substantially reduced in order to make possible a sustainable recovery.

Key words: current crisis, falling rate of profit, household indebtedness, debt reduction

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The US economy recently experienced its worst crisis since the Great Depression. This paper first analyzes the underlying causes of the current crisis, and how the crisis has evolved, and then analyzes what must be done in order to solve the main remaining fundamental problem and make possible a lasting recovery. The final section is a brief consideration of "what lies ahead?". The ultimate question of the paper is: is the crisis over, or is the worst yet to come?

1. The decline of the rate of profit

To understand the fundamental causes of the current crisis, we have to take a long-run view of the entire post World War II period. The most important cause of the poor economic performance in the US economy in recent decades was a very significant *decline in the rate of profit* for the economy as a whole. According to Duménil and Lévy (2002), estimates of the rate of profit for the nonfinancial corporate business sector declined approximately 40% from the early 1950s to the early 1980s. Other estimates of the rate of profit by Roberts (2010) and Shaikh (2011) show a similar trend.

I argue that 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. An 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" was the very significant decline in the rate of profit.

2. Strategies to restore the rate of profit

Capitalists have responded to the significant decline in the rate of profit by attempting to restore the rate of profit in *every way possible*. The last four 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. As a result of these strategies, the average real wage in the US

economy has hardly increased at all since the mid-1970s (Rasmus 2004).

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.

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.

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 have been in Chapter 11 bankruptcy, and they have made very steep cuts in wages and benefits (25% or more).

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.

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.

It appears that this all-out campaign by capitalists to increase the rate of profit in all these ways has been modestly successful in achieving this objective. It has taken a long time, but the rate of profit has recovered most of the previous decline, as can be seen from the estimates mentioned above. And these estimates do not include the profits of US companies from their production abroad, but include only profits from domestic US production. These estimates also do not include the multi-million dollar salaries of top corporate executives. On the other hand, these estimates do include a large and increasing percentage of profits of the financial sector (approximately one-third of total profit in mid-2000s was financial profit), much of which will probably turn out to be fictitious (i.e. anticipated future earnings that are "booked" in the current year, but will probably never actually materialize because of the crisis). All in all, I conclude that there has been a substantial (although not complete) recovery of the rate of profit in the US.

3. Increase of household debt

Surprisingly and disappointingly, the recovery of the rate of profit has *not resulted in a substantial increase of business investment*, and thus has not led to an increase of employment that would normally be expected. Business investment as a percentage of GDP has remained at low levels in spite of the recovery of the rate of profit. Instead, owners and executives have chosen to spend their higher profits in other ways besides investing in expanding their businesses: (1) they have paid out higher dividends to stockowners (i.e. to themselves); (2) they have "bought back" shares of their own company, which has increased the prices of their stock and increased their executive compensation; and (3) they have loaned the money out (e.g. for mortgages), thereby contributing to the financial speculative bubble in recent years. (4) They have invested their profit in low-wage areas of the world, rather than in the US ("globalization" as discussed above). Therefore, workers have not even benefited through the "trickle down" effect of more investment leading to more jobs. Instead, capitalists have spent their increased profits on luxury consumption (e.g. airplanes, expensive automobiles, multiple vacation homes, etc.), and unemployment has remained high.

An important further consequence of the higher profits and the continued weakness of business investment was that banks had lots of money to lend, but non-financial corporations did not have much need to borrow. Therefore, banks searched for new borrowers. Meanwhile, workers were strapped with stagnant wages for decades and were all too eager to borrow money to buy a house or a new car, and sometimes even basic necessities. Therefore, banks increasingly focused on *workers* as their borrower-customers, especially for home mortgages over the last decade or so. The percentage of total bank lending going to households increased from 30% in 1970 to 50% in 2006. The total value of home mortgages *tripled* between 1998 and

2006. And the ratio of household debt to GDP (including both mortgage debt and consumer debt) more than doubled, from 45% in 1970 to 95% in 2007. This was an extraordinary increase of household debt, unprecedented in US history (there was almost no household debt before the 1920s, and the ratio of household debt to GDP in 1929 was 25%).

In this way, the profitability crisis for firms has evolved into an over-indebtedness crisis for households. The strategies used to restore the rate of profit have resulted in unprecedented and very dangerous over-indebtedness for households.

5. Possible solutions to household "over-indebtedness"

It follows from the above analysis that a necessary condition for a lasting solution to this crisis is a *significant reduction in the ratio of debt to GDP, or debt to income*, especially in the household sector. Logically, there are in general three ways to accomplish this necessary reduction in the debt to GDP ratio. These three ways can be illustrated by the following simple equation, which decomposes GDP in the denominator of this ratio into the product of the price level times the quantity of real output produced:

$$\mathbf{D/GDP = D/(PQ)}$$

The three general ways to reduce this ratio are the following:

(1) *real growth*: The preferred way to reduce the debt to GDP ratio is for GDP in the denominator grow faster than the debt in the numerator, as a result of real growth in the economy (i.e. ↑**Q**), without a corresponding increase of debt (↑**D**) (i.e. "grow our way out of over-indebtedness"). Unfortunately, that preferred solution is not very likely to happen in the US economy in the years ahead. In the US economy today, faster growth is possible only as a result of increased debt. But increasing growth and GDP by means of increasing debt does not solve

the fundamental problem of too much debt in relation to GDP. The numerator debt increases almost as much (or more) as the denominator GDP.

(2) *inflation*: A less preferred way to reduce the debt to GDP ratio is to increase GDP in the denominator by means of inflation (↑**P**) (i.e. "inflate our way out of over-indebtedness"). However, inflation would have to be very high for many years in order to be an effective solution to over-indebtedness. Assuming that the debt level remains constant, it would take 4-5 years of 10-15% rate of inflation in order to return the overall private debt to GDP ratio to its 1980 level (and its level in 1929, which was 150%). But if debt remained constant over this period, then there would probably be little or no growth and hence increasing unemployment. So we would have the worst of both worlds, both double-digit inflation and double-digit unemployment. In other words, we would have a return to "stagflation" – and worse stagflation than in the 1970s and 1980s, when the word was coined. So this is not a good solution.

(3) *debt reduction*: There are two main ways reduce debt in the numerator of the debt/GDP ratio: reduce the amount of debt owed through some process of bankruptcy or quasi-bankruptcy, or pay off part of the debt out of current income ("deleveraging").

(3a) *bankruptcy*: The classic way to reduce the debt of businesses (both nonfinancial and financial) throughout the history of capitalism has been through the process of *bankruptcies* of insolvent firms. There are two types of business bankruptcies. In *liquidation bankruptcies*, the assets of the bankrupt company are sold off, and the proceeds are used to pay the creditors of the bankrupt company a fraction of the money owed to them (usually a small fraction), and the rest of the debt is "wiped out". In *temporary bankruptcies* (in which the bankrupt company continues to operate), the creditors accept a significant write-down of the debt (a "haircut", as it is called in the industry), or the creditors agree to convert a portion of their debt into equity in the

newly reorganized company, or some combination of the two, both of which reduce the outstanding debt of the reorganized company (called "Chapter 11" bankruptcies in the US).

But of course this process of bankruptcies of businesses is usually very painful, and results in further disruptions of the economy and a deeper depression, especially liquidation bankruptcies. But in the past these bankruptcies did at least succeed in significantly reducing the overall debt level in the economy, which laid the foundation for a substantial recovery from a crisis.

A similar process of temporary bankruptcies also applies to households (obviously households are not "liquidated"). Personal bankruptcies also wipe out a part of the debt owned to creditors, and the households get a "fresh start" (although with damaged credit ratings), and with less further disruption of the economy than with business bankruptcies.

(3b) *de-leveraging*: Another way to reduce debt is for debtors to *pay down* part of the debt out of their current income, and not renew that borrowing. This method is less painful than bankruptcies in the short-run, but also takes much longer. Paying off debt with current income reduces spending on current output; e.g. less investment by firms, less consumption by households, and less lending by banks, all of which result in slower growth. And since the total debt level now is so high (260%), it would probably take years (like a decade) to reduce the overall debt/GDP ratio to its 1980 level (120%) by means of deleveraging.

6. Government mortgage modification programs

In the current crisis, house prices have declined on average over 30%, and more declines are likely to come. Many economists have suggested that household mortgage debt should be reduced to the current value of the house. This would require on average about a 20% reduction

in the amount owed. This write-down of mortgage debt would go a long way toward the reduction of household debt that is necessary to provide the foundation for a sustainable recovery. Household debt levels would still be high, but they would be less high and more manageable.

But of course the banks and other mortgage investors have strongly opposed such mandatory "write-down" policies, because it would mean recognizing losses for them. And both the Bush and the Obama administrations have given in to the banks, and have missed this key chance to force a reduction of household debt and thus help solve the over-indebtedness crisis. Both the Bush and the Obama mortgage modification programs have been *voluntary* on the part of the banks, and so far very few banks have "volunteered", and both programs have been failures. I suggest that it would be much better for the government to simply mandate: whatever the market value of the house is now, that is the amount that the homeowner owes to the banks. This would force the banks to pay for their own losses, which is the way it should be, rather than taxpayers paying for the banks' losses. So far the household debt/GDP ratio had declined slightly, from 95% to 90%, but still remains twice as high as its 1980 level of 45%.

What lies ahead?

"Deleveraging with slow growth" appears to be the most likely scenario for the US economy in the years ahead. But many years of slow growth would also mean many years of very high (double digit) rates of unemployment, which in turn would eventually cause more defaults on home mortgages and more losses for banks, and which would eventually probably precipitate another serious banking crisis and another severe recession, which would make the bankruptcy scenario more likely.

If another banking crisis does occur, then the government should *definitely not* bail out the failing banks ("never again"), but should instead *nationalize* any large bank that is failing, and operate these banks as public banks (i.e. "public option" for banking). (See Lapavitsas 2009 for an extensive discussion of the further benefits of the nationalization of failing banks.)

However, even the nationalization of failing banks might not be enough to reduce the current very high debt/GDP ratios to sustainable levels, and the economy could still eventually fall into a deeper depression. In that case, the only way to avoid a deep and prolonged depression would be a fundamental change in the economic system, from a profit-making capitalist economy, to a democratic socialist economy, whose main goal would be to produce what people need, rather than produce profit for a minority elite. I hope there will be a broad social movement to accomplish that fundamental change in the US economy, and I hope we will all participate in building that movement.

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