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The Meltdown Chronicles

By Kim Pollock

WORKERS LEFT TO PAY FOR THE RECOVERY THAT WASN'T

The economic boom which lasted from about 2002 into 2007 is now over. Many working families feel as though they are trapped under its wreckage.

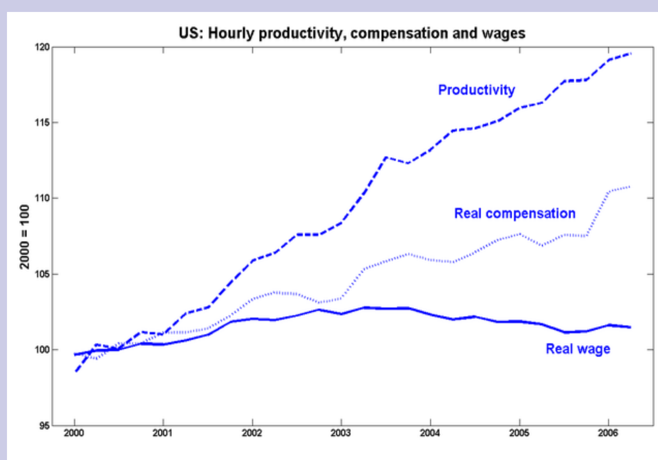
The boom was characterized by a huge jump in corporate profits, which expanded much *faster* than in past recoveries and *vastly more* than workers' wages or investment in new machinery and equipment. Yet ironically, the boom was based on the assumption that *consumer spending* might continually drive increasing economic output and even *more* corporate profits.

Obviously something had to give -- and now it has. The boom has been killed; the resulting crisis has the potential to become the most devastating economic crisis since the 1930s, a massive blow to the prospects and homes of millions of people who worked through the so-called boom with little left to show for it.

A Rosy Recovery – for Corporate Profits…

Starting with the US recovery after 2001, however, things looked particularly *rosy* for US corporations. Profits grew spectacularly, rising 62.1 percent from the trough of recession in 2001 to 2004, as John Miller wrote in the US economic publication *Dollars and Sense*. This compared *extremely* favourably to the modest average growth of profits during previous post-war recoveries, when they went up only 13.9 percent. By comparison, labour compensation (wages plus benefits) increased by only *2.8 percent* after 2001, compared to a post-war average of 9.9 percent following earlier recessions.

This extraordinary growth in profits at the expense of wages was in fact not reversed throughout almost the whole life of the boom. *Forbes* magazine reported in December 2006, for instance, that: "US inflation-adjusted profits rose 31.5 percent during the third quarter of 2006, pushing the profit share of gross domestic product to 14.0 percent – its highest level in half a century." At about the same



time, economists Jonathan Nizer and Shimshom Bichler wrote that "the *ratio of profits to wages* climbed rapidly – rising 250 percent since 2001…"

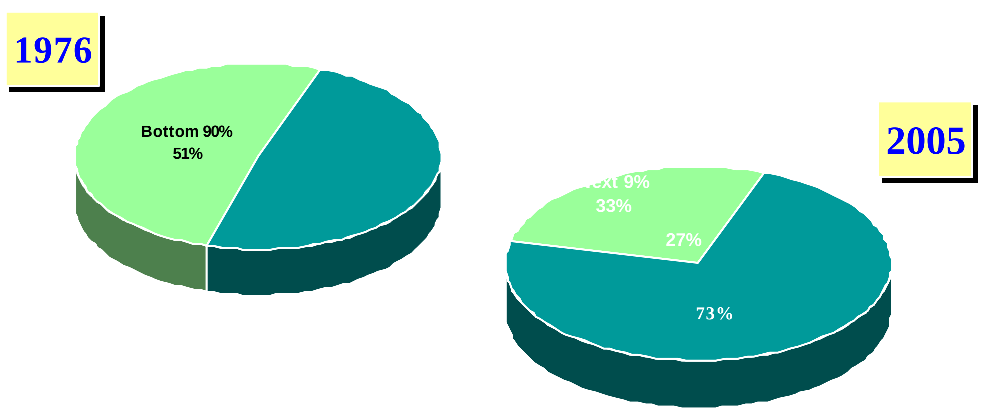
Forbes boasted that this happened because corporations were "successful at raising profits due to productivity and wage restraint," so that by 2006 wages and salaries comprised only 51 percent of national income, compared to 60 percent in 1970. And while productivity – total output compared to the combined costs of capital and labour – rose, profits rose much faster. As a result, companies were free to boost profits by pocketing most of the productivity increases rather than sharing them with workers: "As wage growth slowed," observed *Forbes*, "firms successfully boosted productivity while reducing unit labour costs;" in the non-financial sectors of the US economy, labour costs per unit of output rose only 2.7 percent per year.

"by 2006 wages and salaries comprised only 51 percent of national income"

…Investments in the Stock-market, not Production

The resulting expansion of profits at the expense of wages "caused corporate savings to surge," says *Forbes:* undistributed corporate profits rose to $700 billion in late 2006, up from less than $100 billion in 2000. Investment as we have noted, meanwhile, was "modest in relation to profit growth;" Bureau of Economic Analysis statistics show that average annual manufacturing investment averaged only 6.8 percent from 2003 to 2007. In other words, billions of dollars that might have gone into revitalizing US industry and ensuring steady job-creation were instead diverted from productive activity into financial dealing. Corporations used a big chunk of this extra cash on hand to "engage in an unprecedented volume of share buybacks," says *Forbes*.

Another place these massive profits went was into huge corporate salaries, dividends and via rising share prices, pay-outs to investors and corporate shareholders. We can see from this graphic how this boosted the wealth in the hands of the richest 10 percent of households; their incomes rose from about half of household revenues in 1976 to *almost three quarters* by 2005:



As we now know, the bulk of this huge and growing volume of uninvested corporate profits and private wealth was poured into stock-market speculation. Federal Reserve statistics indicate, for instance, that between 2003 and the end of 2007 the total of credit-market assets held by US financial corporations increased by 40 percent; over the same period, the credit-market

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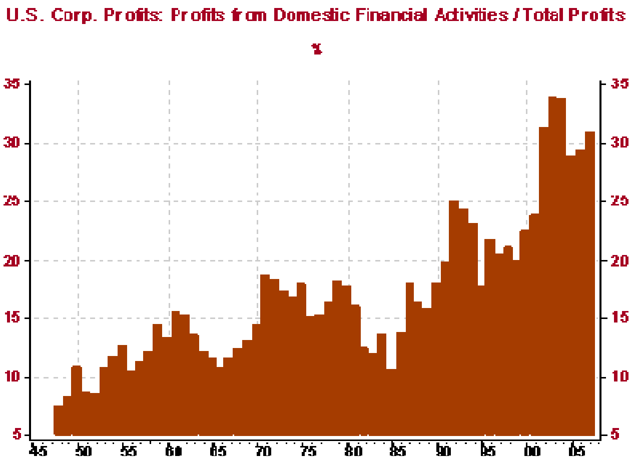
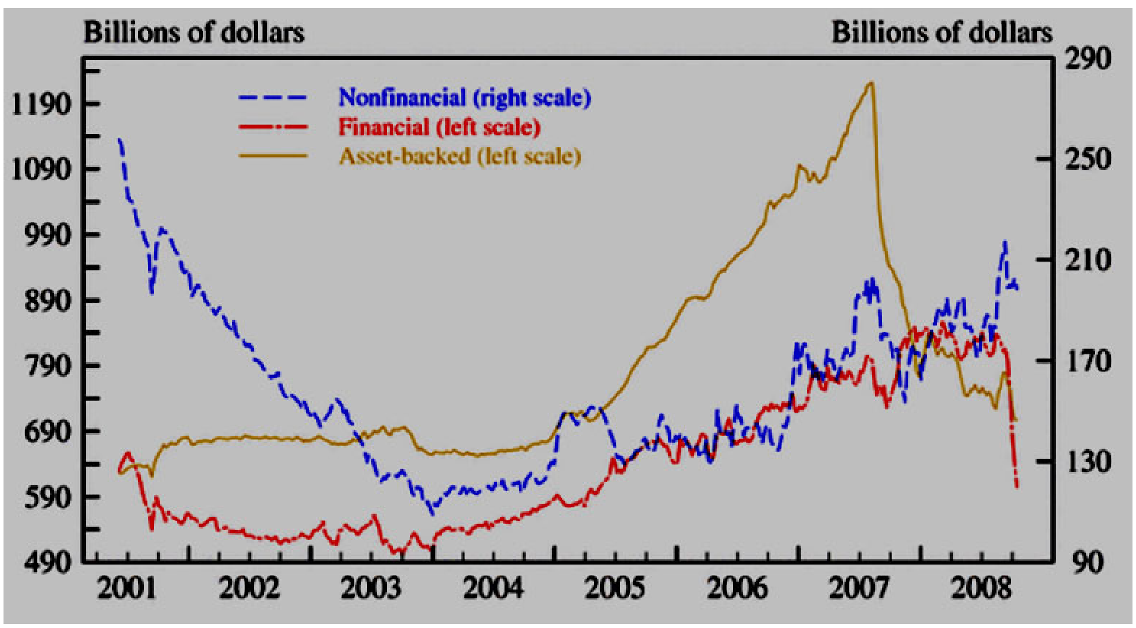


assets of non-financial corporations actually *fell* by more than one percent. Why? Profits available in the financial sector exceeded those being generated by US industry or investments back into production. The following graph shows in fact that during the past few years the profits made in finance therefore rose to *historical highs*, in excess of 30 percent of total corporate profits.

"the US now luxuriates in finance at the expense of harvesting, manufacturing or transporting things"
- Kevin Phillips

Growing amounts of capital thus flowed into a wide range of often-complex and highly-speculative financial assets at the expense of investment in US industrial employment and competitiveness. Chief among them were so-called "asset-backed" securities:



It's all part and parcel of what US writer Kevin Phillips describes as the "financialization" of the economy -- the US, he suggests, now "luxuriates in finance at the expense of harvesting, manufacturing or transporting things."

A 2007 paper on the effect of financial investment in capital formation in the industrial sector by Özgür Orhangazi of the University of Massachusetts shows that financialization slows down capital accumulation, especially for large firms. Orhangazi's investigations "support the view that financialization has negative implications for firm investment behavior… The negative effects of financialization on investment confirm the concern that financialization could be slowing down the accumulation of capital" and that "overall, the nature of the relationship

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between financial markets and NFCs does not necessarily support productive investment. On the contrary, it might be creating impediments."

In search of relatively-high and relatively-easy profits, growing amounts of capital flowed into a wide range of often highly-speculative financial assets, in particular those mortgage-based securities that have now done so much to damage the solvency of banks, financial institutions and corporations.

"much recent job loss in manufacturing and other sectors of the economy can be traced directly to "unbalanced U.S. trade with China"

… Billions flow Offshore…

At the same time the search for higher profits also led corporations to ship *offshore* literally millions of jobs and billions of dollars in investment capital. The US State Department said earlier this year that "U.S. companies have entered agreements establishing more than 20,000 equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises in China," within the past 10 years. "More than 100 U.S.-based multinationals have projects in China, some with multiple investments. Cumulative U.S. investment in China is estimated at $57 billion, through the end of 2007, making the United States the sixth-largest foreign investor in China."

Much of this investment went into in consumer and capital-goods producing sectors that actually were sold back into the US market. As a result US imports from China grew astronomically, up 12 percent in 2007 alone, bringing the US *trade deficit* with China to $256 billion from $84 billion in 2001. According to the Economic Policy Institute, much recent job loss in manufacturing and other sectors of the economy can be traced directly to "unbalanced U.S. trade with China" which "since 2001 has had a devastating effect on U.S. workers. Between 2001 and 2007, *2.3 million jobs* were lost or displaced, including 366,000 in 2007 alone."

The reason that so much capital flowed offshore rather than into domestic production is again simple: higher profits. A report in March by Martin Sullivan in the on-line publication *Tax Analysts* shows that US multinational corporations' US operations saw profits *fall* by 1 percent between 1999 and 2005. By comparison, those same firms' *foreign* affiliates saw profits increase by *72 percent*. No wonder then, as Sullivan points out, the share of total US corporate profits generated offshore rose from 26.7 percent in 1999 to 33.9 percent in 2005. Corporate profits earned abroad jumped 45 percent in 2007 and were expected to climb another 25 percent this year, the New York *Times* reported earlier this year. At the same time, U.S. profits earned domestically turned negative in the third quarter of 2007.

McDonald's international operations, for example, drove a 24 percent rise in the company's quarterly operating profit; U.S. companies with big foreign exposure are also more likely to surpass their earnings estimates, the *Times* says. About 57 percent of a sample of 450 companies from the Russell 1000 stock index exceeded earnings-per-share estimates. Of that group, the 95 companies deriving more than half their revenues outside the United States exceeded estimates about 68 percent of the time, compared with a 46 percent rate for those with no international sales, according to Bespoke Investment Group.
And a lot those profits made offshore *never* find their way back into the US or American industry: the profits of foreign subsidiaries of U.S. corporations in 18 tax havens swelled from

$88 billion in 1999 to $149 billion in 2002, according to the online publication *Tax Notes*,, which cited U.S. Commerce Department data covering the years 1999 to 2002. Total profits of U.S. multinationals' foreign subsidiaries around the world stood at $255 billion in 2002, *Tax Notes* says; however those 18 tax havens were home to *58 percent* of the foreign profits of the multinationals—a figure that far exceeds the share of economic activity that multinationals actually conduct in those low-tax countries, according to the report.

… But the Boom Proved Brutal for Working Families…

"If the 1990s were the jobless recovery, this decade saw the prosperity-free recovery"

The boom is now over, as this table shows:

Stock Market	⇩ **45%**	**Fastest decline since the Great Depression**
Home Prices	⇩ **17%**	**Largest decline on record**
Dow Commodity Index	⇩ **50%**	**Largest decline**
Consumer Confidence	⇩ **45%**	**Largest decline ever**

While it lasted, it provided a moment of bliss for bankers, financiers and corporations. But it was *brutal* for workers, especially in the manufacturing sectors. If the 1990s were the "jobless recovery", this decade saw the "prosperity-free recovery". Profits rose annually by 49.3 percent, 24.8 percent and 4.0 percent respectively in 2005, 2006 and 2007. Manufacturing value-added grew less spectacularly but nonetheless steadily: 3.9 percent, 4.4 percent and 4.2 percent. But wages noticeably and stubbornly trailed profits and output, growing only 2.4 percent, 3.5 percent and 3.7 percent per year respectively. Worse, productive-sector *employment* was being hammered, losing 0.4 percent in each of 2005 and 2006, falling by another 1.7 percent in 2007.

And yet as we have noted, the boom was ironically and tragically designed on the dangerous assumption that accelerated US *household spending* would and could provide sustained economic growth. And indeed, over 90 percent of economic growth after 2001 actually consisted of house-price inflation and consumer spending, according to UCLA historian Robert Brenner. In fact, the US Federal Reserve made this an official element of policy, vigorously cutting interest rates: faced with a recession, Fed chairman Alan Greenspan cut rates *eleven times* in a year after January 2001, a combined fall from 6.5 percent to 1.75 percent.

Workers' *wages* nonetheless remained stagnant, as we have seen. So what did working families do to maintain their falling incomes? Some took extra jobs or worked overtime, often unpaid: "The number of hours per year worked by the average American worker has risen by about 20 percent since the 1970s," University of Massachusetts economist Rick Wolff reported recently in *Dollars and Sense*. More family members went out to work, raising house-

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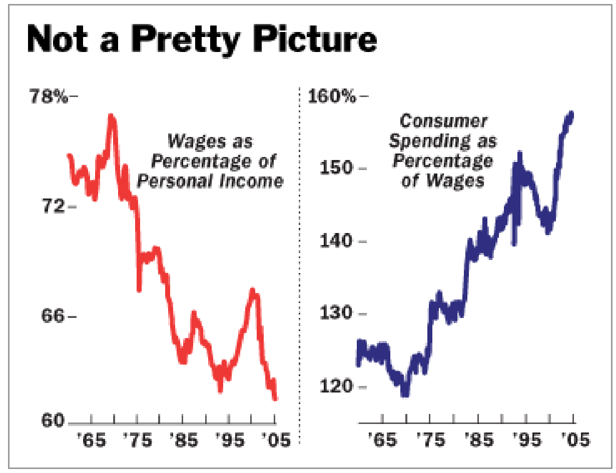
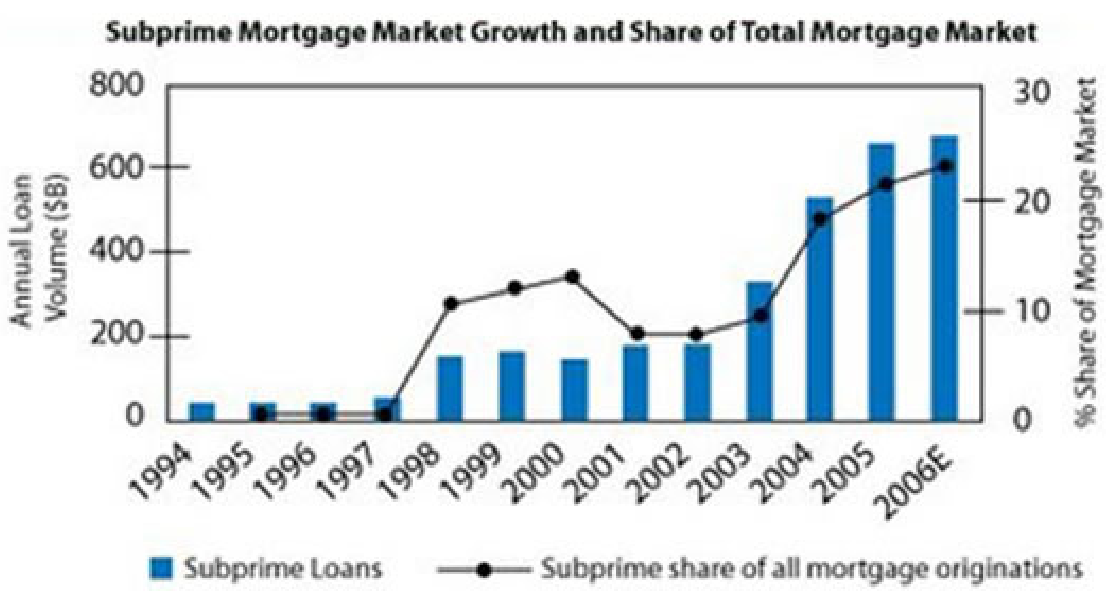
hold incomes but also increasing costs such as transportation and child care. A greater number of workers were generating profits but on the whole each worker's wages remained low.

"hundreds of thousands of consumers took out subprime loans: by 2006 subprime mortgages made up over a quarter of total US mortgages"

Presented with the faint hope of low interest rates in place of wage increases, working families also responded by *borrowing* massively. "Workers could consume ever more" and as a result "profits (were) exploding in every category," suggests Wolff. "Underneath the magic, however, there were workers who were completely exhausted, whose families were falling apart and who were now ridden with anxiety because their rising debts were unsustainable." The following graph shows this depressing reality in glaring terms: while wages fell in the past six years, *consumer debt* has skyrocketed.



This helps to account for the sudden growth in the number of subprime mortgages, those economic poison pills that ultimately *brought down* the boom. Presented with the possibility of buying a house – whose rising price might also provide a constant source of cash – hundreds of thousands of consumers took out subprime loans: by 2006 subprime mortgages made up *over a quarter* of total US mortgages. They were easy to obtain – but proved difficult to keep.



By 2007, it was clear that many of the families holding those mortgages were running into *trouble:* unexpected job loss or a sudden medical emergency might combine with the sudden "reset" of subprime loans – interest rates were calculated to rise from early low or non-existent interest rates to higher rates after a year or two – to drive them into default or foreclo-

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sure. Not only did banks discover that they held thousands of *non-performing* mortgages; it was soon clear that a portion of all the financial dealing going on was in so-called "asset-backed" securities based on subprime mortgages, as we have noted.

When the magnitude of the subprime problem became apparent, some lenders called in the borrowed cash that was fuelling much of the subprime asset-backed speculation – investment bankers, brokerages and banks were borrowing on average $30 for every $1 of their own assets. This caused the whole financial house of cards to suddenly collapse.

… So that Now, Many people find themselves Trapped in the Wreckage

As a result, the US economy has been *doubly wrecked*. It was wrecked by record levels cash in the hands of corporations and speculators, who pushed up the value of mortgage-based securities and other dodgy assets and in the end, destroyed the financial markets. But even more devastating has been the impact of the financial crisis on the real or productive economy, which is now seized by corporations' *unwillingness* to invest and working families' *inability* to spend.

As a result, the economy now seems poised on a downward spiral into *deflation* – as companies curtail production and lay off workers, further driving down spending and cutting investment even more. Without either an economic *miracle* or significant political intervention, this will lead to even more layoffs, curtailments and spending cuts; a sure-fire recipe for a deep recession. The latest figures from the US Department of Labour reveal that employers cut 533,000 jobs in November, sending the unemployment rate to 6.7 percent – a 15-year high, having jumped from to 6.5 percent in October; that's also the biggest *monthly* spike in job losses in 34 years.

Meanwhile, the average workweek for production and non-supervisory workers fell to 33.5 hours—the "lowest in the history of the series," according to the DoL. "That means that many businesses are reducing hours in an attempt not to lay off people, but even these measures may prove futile if the recession continues," says the Centre for American Progress. "It also means that workers fortunate enough to still have a job are earning less money because they are working fewer hours."

Certainly whether employed or laid off, many workers are not in much of a position to help the US spend its way out of a recession Already by the end of 2007, total US consumer debt (which includes credit-card debt and non-credit-card debt but not mortgage debt) reached $2.55 trillion at the end of 2007, up from $2.42 trillion at the end of 2006. And total U.S. consumer revolving debt (including mortgages) reached $962 billion in May 2008, up from $879 billion at the end of 2006. About 98 percent of that debt was credit card debt, says the Federal Reserve.

In addition, the subprime mess is far from behind us. Hundreds of thousands of US families remain ensnared in default or foreclosure; many others are barely hanging on. And because of subprime loan resets, many more will soon hit the wall without some form of government intervention, as the adjacent graph suggests.

"Hundreds of thousands of US families remain ensnared in default or foreclosure"

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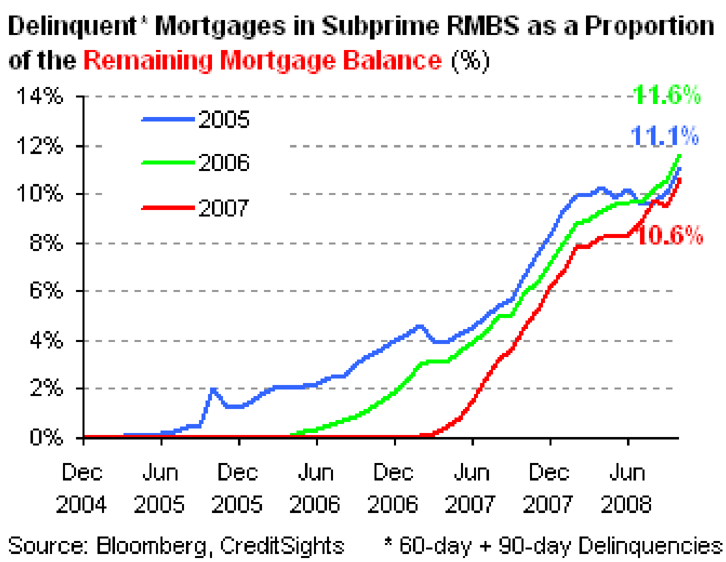
And while many Americans are now deeply in debt, many others who actually *have* some form of savings plan have lost all or some of it. The business weekly *The Economist* reports that according to the national association representing US mutual funds, those funds last $2.4 trillion less at the end of October than a year before; the Congressional Budget Office reported in October that US pension funds had lost $2 trillion in the preceding 18 months.



As more workers become unemployed, of course, more and more people will lose all or some of their pensions and be unable to save at all. Already, reports AP, consulting firm Mercer says pension plans sponsored by the 1,500 biggest US companies hit a record funding deficit of $280 billion by the beginning of December.

As is always the case, in other words, the speculators are now long gone. Many got rich, a few went broke. But working people are left holding the bag – left to pay through their taxes and resulting service cuts for the bailouts and backstopping of loans; left unemployed or fearing job loss; left trying to hang onto their jobs, homes or retirement savings; left wondering whether, after the banks and auto companies have received assistance, someone will ever bail *them* out.

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