Special Report

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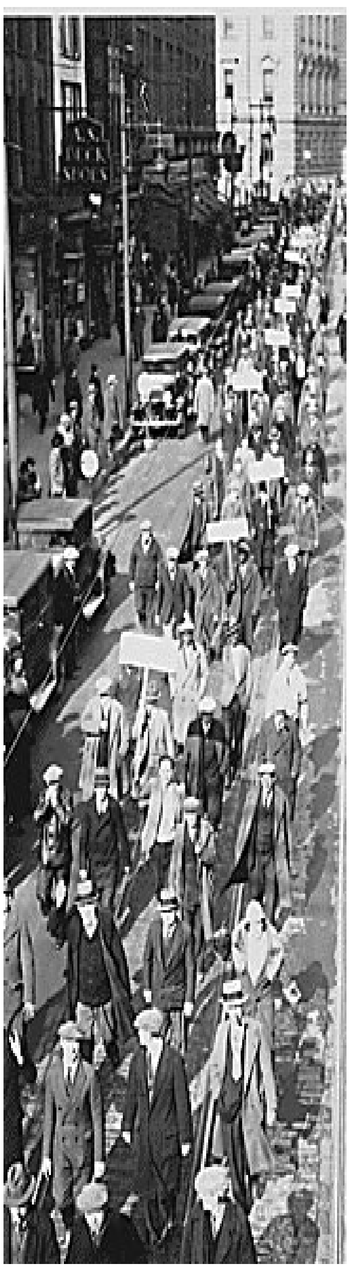
#4

The Meltdown Chronicles

THE FUNDEMENTALS ARE FINE? TELL THAT TO THE UNEMPLOYED

By Kim Pollock



In the realm of economics, we can only hope that 2008 goes down as the worst year in most people's lifetime. Because it was horrendous, as almost anyone can tell you. Yet throughout the entire year the Bush administration worked hard to convince Americans that their country's "economic fundamentals" were "sound".

Mislead or Misinformed?

In March President Bush stated: "In the long run I am confident that our economy will continue to grow because the economic foundation is solid."

In July, treasury secretary Henry Paulson claimed that in spite of growing problems in the housing and banking sectors, "our economy has very strong, long-term fundamentals" and the banking system was also "sound".

Even in September, as stock markets began to melt down and the government moved to bailout investment bankers, insurance brokers and even the mighty, quasi-public mortgage lenders Fannie Mae and Freddie Mac, Republican presidential candidate John McCain said that in spite of "tremendous turmoil" on Wall Street, "the fundamentals of our economy are strong."

Obviously, they were either misinformed or trying to mislead us.

It's pretty obvious that the "economic fundamentals" were actually anything but sound, in either the US or Canada. In fact, the statistical agency charged with tracking recessions reported in November that the US economy had entered a recession in December 2007!

US: Unsound by Any Measure

No matter how you describe the economy's fundamentals, the American economy was unsound last year and will be even less sound in the foreseeable future.

Start with the rate of profits. The rate of profit it crucial because it essentially directs investment capital and therefore job creation from one sector to another as companies and investors respond to opportunities to

make more money. By this measure, US corporations have been struggling for some time. As this graph shows, in spite of a rise after 2002, the profit rate fell steadily until the 1980s, never recovered to anywhere near its level of the 1950s and with the recent slump, has fallen sharply once more.

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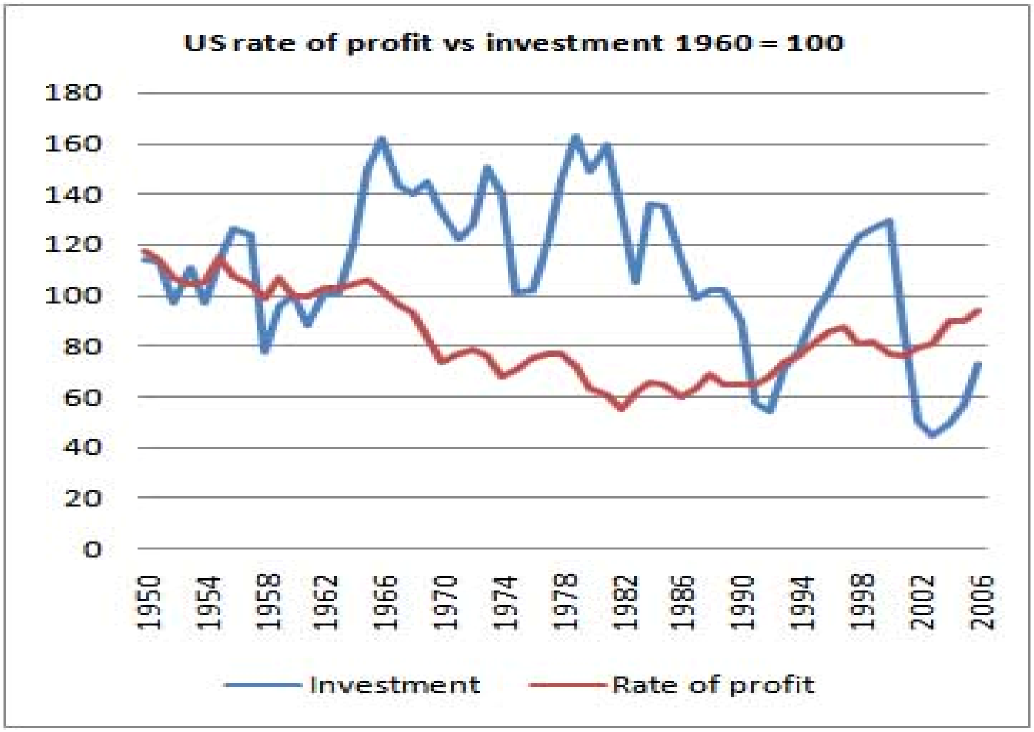
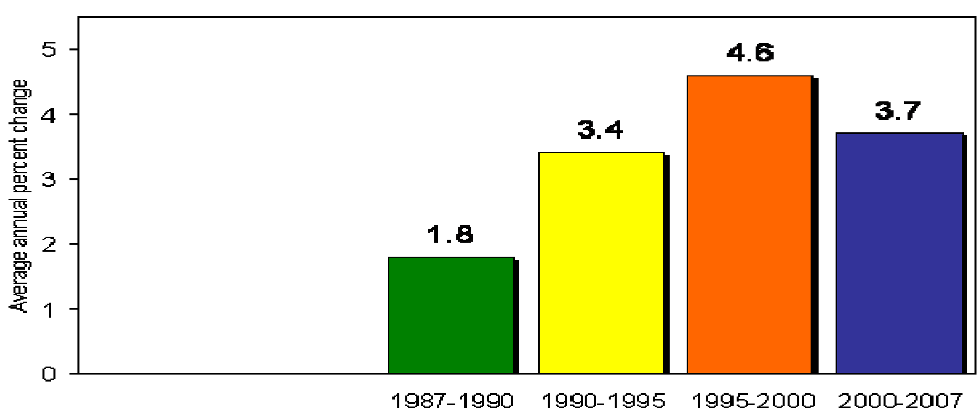


Similarly, if you think of investment, the graph also shows that despite ups and downs, that's declined, as well. Investment is a major determinant of how many jobs there will be in the future, what kind of jobs and where. Less investment of course means fewer new jobs and less international competitiveness for the US as US industry becomes increasingly worn out and obsolete. And in fact, there has been a sharp drop in US manufacturing productivity recently:



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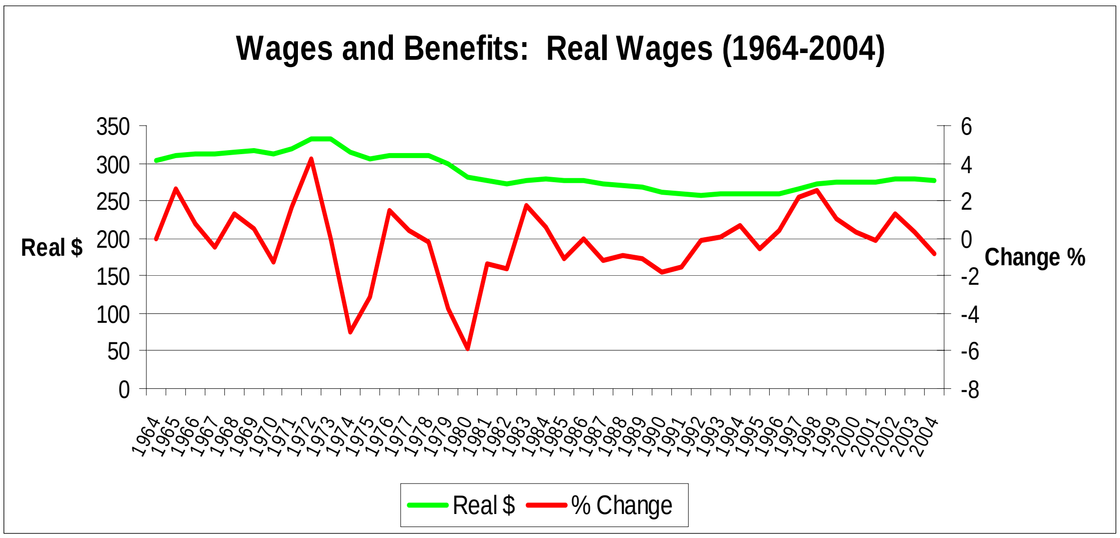
Many of the US manufacturing sector's problems can be traced to the growing US trade deficit with China. Between 2001 and 2007, 2.3 million jobs were lost or displaced – including 366,000 in 2007 alone, reports the Economic Policy Institute – by the mounting U.S. trade deficit with China; the deficit rose from $84 billion in 2001 to $262 billion in 2007.

This also helps account for a near-steady fall in US real wages, by the way. While money wages – workers pay measured in dollars and cents – have risen, real wages – the amount workers' pay will actually buy when you take inflation into account -- have fallen almost steadily since the early 1970s and as this graph shows, are now lower than in the early 1960s:



"American investments in China alone rose from $17.6 billion in 2004 to $28.3 billion in 2007"

Even during the recent economic boom, with low unemployment rates across the US, competition from low-wage countries like China and falling unionization rates helped employers keep wages low. The threat was real enough, too. Between 1976 and 2007, US corporate investments outside the US rose from $222 billion to $3.3 trillion.

American investments in China alone rose from $17.6 billion in 2004 to $28.3 billion in 2007. In other words, jobs were being shipped offshore by US corporations. The China Economic Net reported in October, for instance that 483 of the Fortune 500 list of the world's biggest companies are now operating in China, operating 4,100 plants and operations Total global foreign direct investment in China in 2006 totalled $69 billion.

No wonder China will likely overtake the US as the world's largest manufacturer sometime in 2009, according to forecasts by Global Insight Inc. for the UK-based Financial Times. China is expected to account for 17 percent of global manufacturing value-added by the end of the year, compared to 16 percent for the US. In 2007 the respective shares were 20 percent for the US, 13.2 percent for China; in 1990, China had only 3 percent of the world's manufacturing, the US, 28 percent!

All this foreign investment has contributed to the huge and growing US trade deficit. The US deficit in merchandise trade has risen sharply, from about $100 billion in 2000 to nearly $220 billion in 2008. And US imports are hardly confined to cheap consumer goods or raw materials; as we can see from this graph, US imports of machinery have also grown rapidly, as has the deficit in machinery trade:

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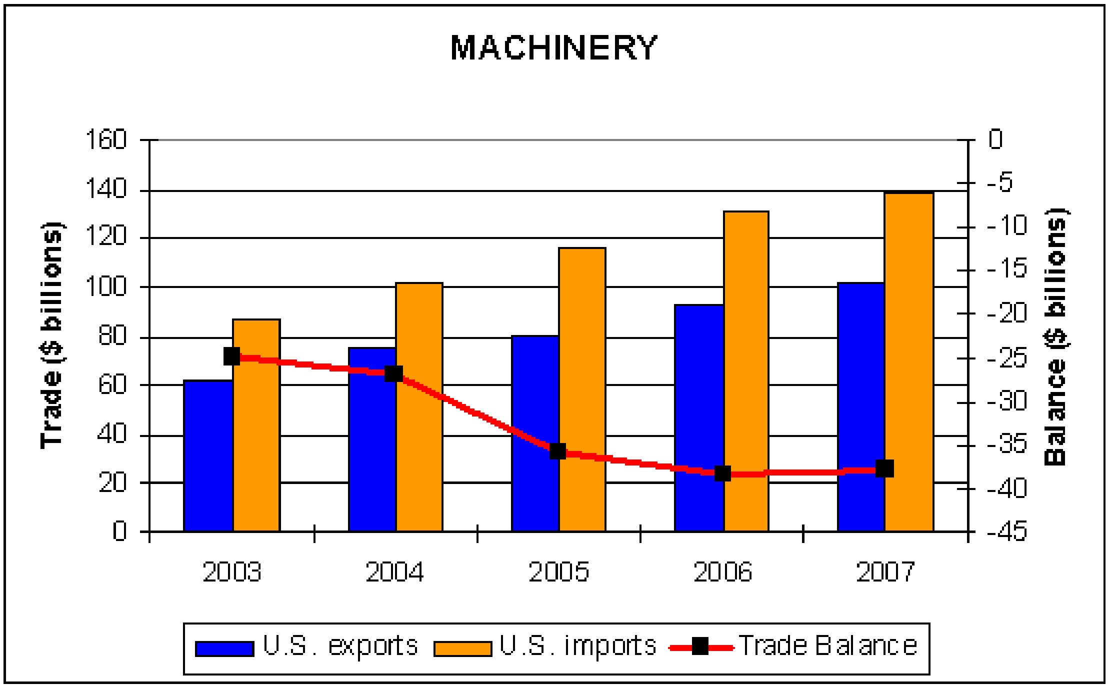
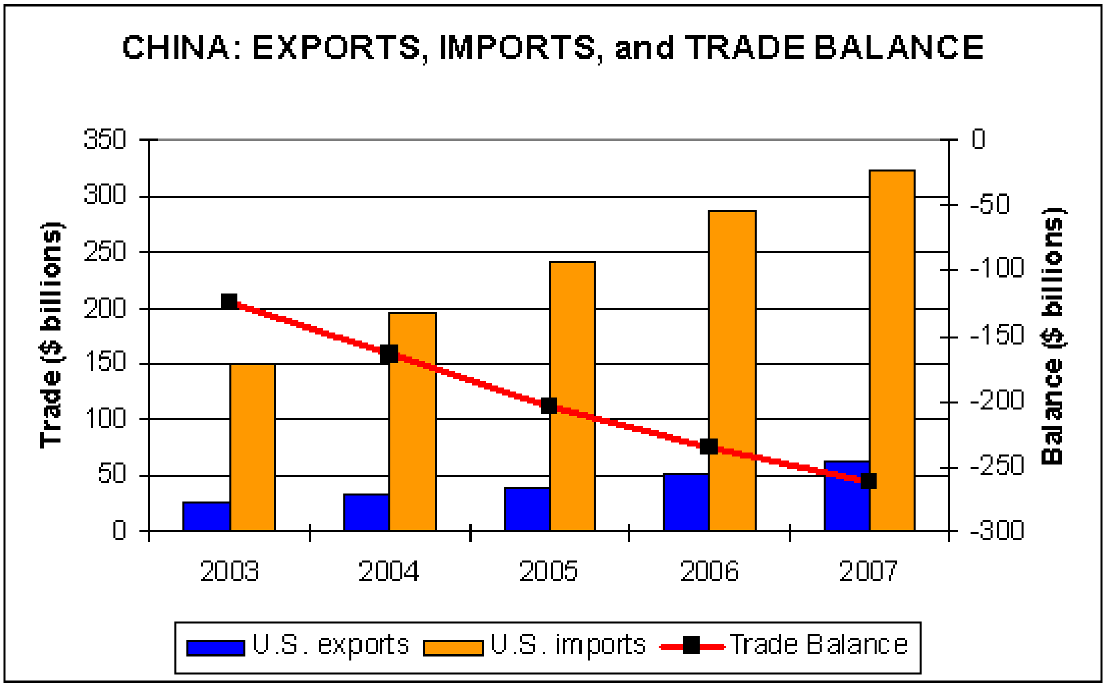


"Meanwhile, as productivity declines in the US and as Chinese manufacturing capacity increases"

In fact the trade deficit with China is the largest of all, exceeding in fact the total US deficit with the rest of the world. In other words, while the US maintains a positive balance in its other global trade, trade with China plunges the US into a trade deficit position. Meanwhile, as productivity declines in the US and as Chinese manufacturing capacity increases, the US is having an increasingly difficult time penetrating the Chinese market at all:



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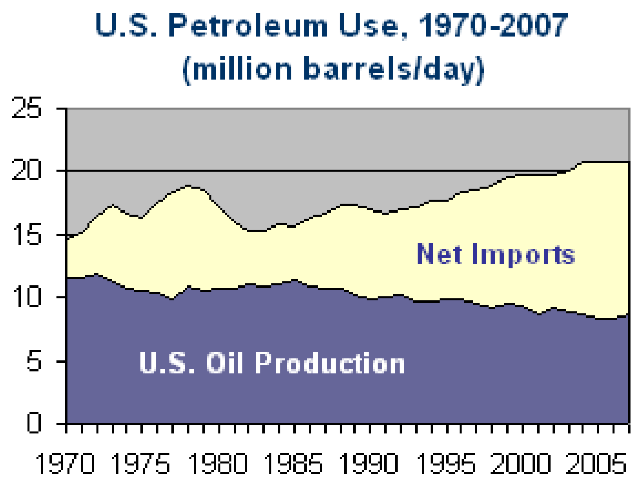
Of course, that's not the only deficit that matters. The US also has a growing energy deficit. Today, over half of the oil the US uses (58 percent in fact) is imported. The US Department of Energy notes that: "Oil price shocks and price manipulation by OPEC have cost our economy dearly – about $1.9 trillion from 2004 to 2008 (alone) – and each major shock was followed by a recession."



Source: EIA, *Annual Energy Review 2007*, Table 5.1, June 2008.

"So if the American economy's fundamentals are sound, a reasonable question is "which part of them?"

There's also the US budget deficit, projected at $1.2 trillion – bigger than Canada's entire GDP in 2007, by the way -- even before the Obama stimulus plan is added in: it will likely take the deficit to $1.6 trillion.

So if the American economy's fundamentals are sound, a reasonable question is "which part of them?" Because let's see: investment in manufacturing and productivity have fallen, making the US increasingly uncompetitive; the rate of profit has tended to fall over a very long historical period; real wages are stagnant, which is what's behind the huge rise in consumer indebtedness and falling consumer spending; international trade is massively and increasingly in deficit; the banking system has taken a huge whack and had to be bailed out by the government; the government deficit is huge and growing. Where are the "sound fundamentals" in that?

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Mislead or Misinformed?

Obviously the now-discarded Bush administration was out of touch with the economic reality of the US and simply trying to lull Americans to sleep. This helps explain the sombre tone of President-elect Barack Obama's inaugural speech. The US needs strong economic medicine; Obama knows many Americans will not like it.

Simply put, the US is currently consuming more than it produces. Income is vastly ill-distributed; those who do work get too little in return while those who don't get too much. Workers' wages and corporate profits' have stagnated for a generation. Yet at the same time, the US also faces stiff competition from countries whose main asset is cheap labour. And much of the investment there is by US corporations. This is one of the biggest obstacles in the way of rebuilding the US economy: many companies are quite happy with the status quo.

The American economy crashed and burned following an attempt to build a consumer-led boom. It was an easy way out of the impasse in the US economy. Perhaps it's time to turn to a production-led boom instead. That is the thinking behind Obama's huge stimulus package, aimed to stop the spiral into recession by spending on major projects like infrastructure, public buildings and alternate energy. But there's no guarantee that corporations will willingly invest in those things; if not, the government will have to do it.

Will it work? It's too soon to tell. But it beats doing nothing, all the while claiming the fundamentals are fine, everything is rosy and we should all relax.

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