DOLLARS & SENSE

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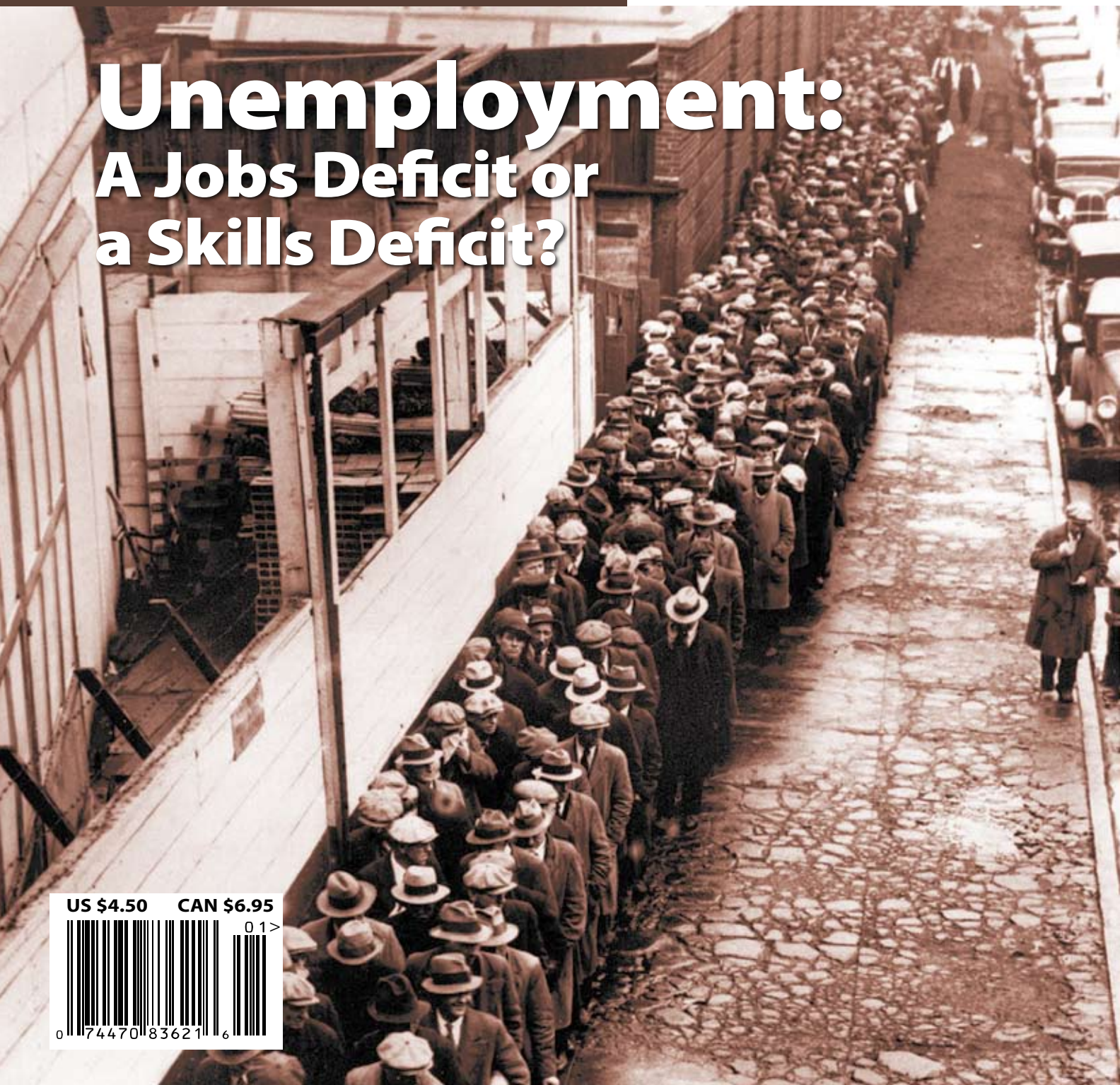
Unemployment:
A Jobs Deficit or a Skills Deficit?



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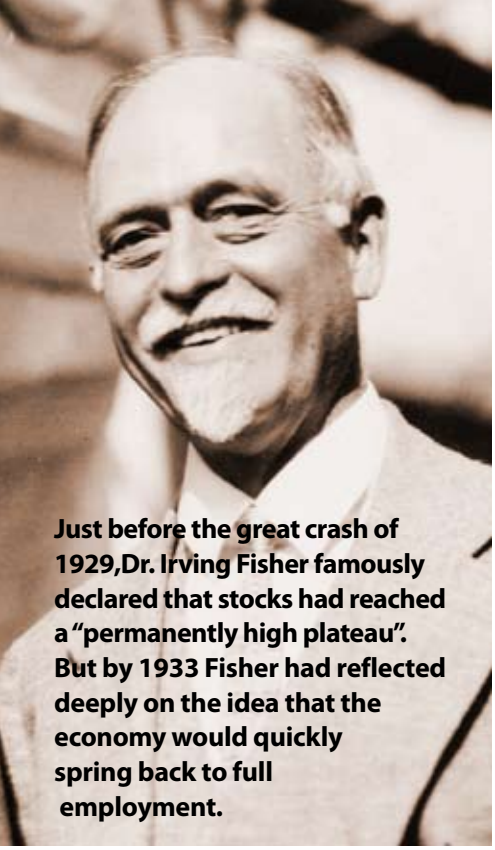


Just before the great crash of 1929,Dr. Irving Fisher famously declared that stocks had reached a "permanently high plateau". But by 1933 Fisher had reflected deeply on the idea that the economy would quickly spring back to full employment.

Beyond Keynesianism

Irving Fisher's Depression-era debt-deflation theory, then and now.

BY JAMES M. CYPHER

According to dominant economic ideas, massive government interventions beginning in 2007—by way of Keynesian fiscal stimulus programs of the Bush and Obama administrations, the TARP program (the Wall Street bailout), and unprecedented interventions by the Federal Reserve—should have reset the economy. But because these interventions have not addressed the economy's huge *structural* issues, the economy continues to stall. Structural changes have brought an end to the era when wage increases were tightly linked to productivity increases from the end of World War II through the early 1970s. Since then, in a new era of deregulation, globalization, and de-unionization, labor productivity has nearly doubled, but real hourly wages for non-supervisory workers—over 80% of the workforce—have stagnated or fallen slightly for over 30 years. This has left the working class without any viable strategy as jobs were offshored and outsourced. Instead, women flooded into the workforce, workers sought second jobs, money was pumped into 401(k)s in the hope that stock market plays could make up for declining labor opportunities, household debt reached record levels, and the dream of windfall gains from house-flipping became a major focus for millions of working-class and middle-class families. From 2007 onward, the unprecedented interventions of the Bush and Obama administrations were designed to meet the immediate needs of elite financial institutions, leaving largely unaddressed the sorry plight of the dwindling middle and working classes, now marginalized in the new era of neoliberalism.

The stimulus and rescue programs did prevent an even greater avalanche of interlocking bankruptcies from reverberating via Wall Street to Main Street and back again—as occurred for years during the Great Depression of the 1930s. Yet as of the end of 2010, the general state of the U.S. economy looks bleak. With the economy losing over 443,000 jobs from June through September and unemployment rising again in November to an official rate of 9.8%, attention shifted toward further stimulus. By September, with most of his original $787 billion stimulus plan now spent, President Obama at first urged $50 billion for new infrastructure projects. There is a bit of buzz about a "manufacturing strategy"—a belated attempt to address the long-term collapse of the manufacturing sector from nearly 30% of the economy in 1953 to only 11% in 2009. Here, Obama has offered only increased funding for the Export-Import Bank in order to meet his goal of doubling U.S. exports by 2015. And then, in December 2010 came a "second stimulus" package largely limited to extensions of existing tax breaks—nearly 25% of which will go to the richest 1% of income recipients. Additional stimulus will come only from a $110 billion one-year drop in Social Security taxes and—according to White House estimates—roughly $50 billion in new investments due a variety of tax breaks for corporations and small business. But, the same legislation eliminated the "Make Work Pay" provision, which had been worth roughly $55 billion in tax cuts. Thus, for all the fanfare, the net new stimulus from this bill will be no more than $105 billion. In short, the administration proffers small and unimaginative policies as the economy stagnates and weakens.

Still, the interventions *have* served the purpose of putting a squishy floor underneath the collapsing edifice. All available evidence tends to support the Obama administration's claim that its fiscal interventions have saved or created some 2.7 million jobs. But these numbers constitute a counterfactual that is hard to demonstrate to the general public: the job growth owing to the stimulus has taken place in a broader context of massive job cuts—roughly 8 million jobs lost—since the downturn began. Economists Alan Blinder and Marc Zandi estimate that had it not been for a range of extremely active monetary and fiscal interventions beginning in the closing months of 2008, GDP in 2010 would have been 10.5% lower and an additional 8.5 million Americans would be out of work. Nonetheless, the public mostly rejects the assertions of Obama's economic spokespersons, either because most Americans have never learned of Keynesian economics or because they have been stampeded by a well-greased juggernaut financed by people like Pete Peterson, the Koch brothers, and the many others who would like to return the U.S. political economy to the good old days of 19th-century Social Darwinism.

Neoclassical to Neoliberal: Economic Theory in a Circular Process

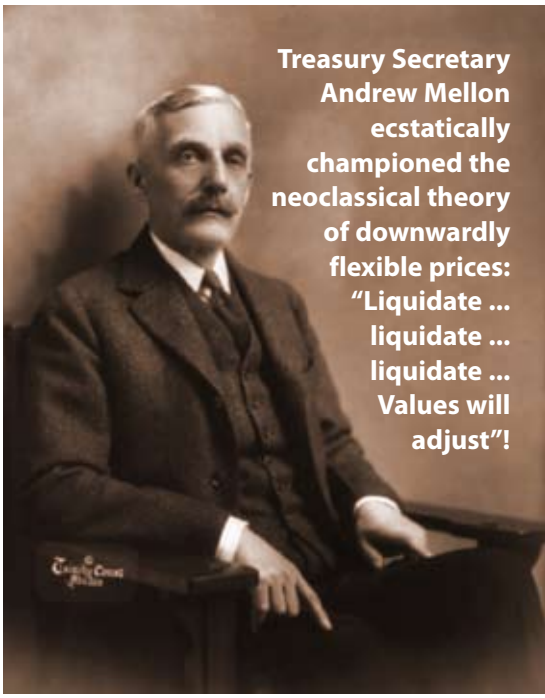
The new era of neoliberalism, which has reigned since the late 1970s, has been anchored in an attempt to sweep away the New Deal policies that had guided the economy during the Keynesian interlude (1933-1978). Prior to the Great Depression economists strongly embraced the neoclassical doctrine of self-adjusting markets seamlessly functioning to bring about a full employment "equilibrium." Any time the economy tended to slow down—causing unemployment to rise as profit, production, and general business activity declined—wages would decline, raw material prices would drop, wholesale prices would plummet, etc. According to received neoclassical dogma, cheap wages, cheap raw materials, readily available credit and under-priced machinery and equipment would all constitute a seductive combination for business interests who would then jump back into the market—hiring workers, building new plants, buying up raw materials, taking on bank loans in order to enjoy an unbeatable profit-making situation. Other things remaining the same, went the argument, the deflation of the economy would create its own recovery momentum as sharp traders availed themselves of a once-in-a-lifetime opportunity.

This approach assumed the economic system functioned as if it were a mechanical apparatus that was somehow "invested with a tendency to an equilibrium." Equilibrium was noted in the fall of 1929, shortly before the great stock market crash, by the most acclaimed economist of the day, Dr. Irving Fisher. Fisher stated that stock prices had reached a "permanently high plateau," adding in September of 1929, as stocks began to crater, that there could not be "anything in the nature of a crash." In the same month President Hoover's powerful Treasury Secretary Andrew Mellon—scion of the robber baron financiers who ran the Pittsburgh-based "House of Mellon"—proclaimed that the "high tide of prosperity will continue." So ended what was, until then, the longest continuous expansion in U.S. history. Prior to the crash the era was dubbed the "New Economy," wherein recession and downturns were understood as things of the past. So, too, the information technology boom of the 1990s was dubbed a "New Economy." In the 1990s, across the United States, congenitally blind economics departments scrapped almost all of their few remaining courses on business cycles.

When the depression of 1929-1939 began, Treasury Secretary Mellon—known as a financial prodigy—ecstatically championed the neoclassical theory of downwardly flexible prices: "liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate … Values will adjust … "! In other words, after a brief bought of deflation, the economy would, in machine-like fashion, quickly restore its balance; the inevitable forces of the New Economy would spring back into motion and the U.S. economic ascent would resume.

Indeed, as the real value of the GDP dropped like a stone from late 1929 through 1933, wages and prices did fall. Autoworkers' money wages fell by 64%, miners' wages plummeted by 74%, steelworkers wages dropped by 62%, and the wages of agricultural workers—one-quarter of the economy was engaged in this sector—fell by 50%. Meanwhile prices in general fell by about 25%. (However, wage and *salary* income—crucially including managerial and executive incomes—apparently fell by *less* than the price level. For a few privileged employees with outsized salaries the standard of living *rose*.)

According to neoclassical theory, the dramatic drop in real wage income—spread throughout the vast manufacturing sector—should have been an inducement for businesses to invest. Along with cheap money, cheap machinery, and cheap commodities, lower wages should have been more than sufficient inducement to restore the economy to high levels of employment at lower price levels. The New York Federal Reserve Bank—the most important in the system—dropped its interest rate from 6% in 1929 to a record low of 1.5% in May 1931. But business cut and cut its investment level: while investment accounted for only 19.3% of GDP in 1929, 56% of the total drop in GDP from 1929 through 1933 was due to *the decline* in investment! The leading sector of the New Economy of the 1920s had been the auto industry. By 1933 real auto production had fallen by 65%—hardly a situation that would encourage the expansion of plants and equipment, the low cost of labor, machinery,



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(Facing page) Irving Fisher, 1927.

Credit: Library of Congress.

Andrew W. Mellon at the beginning of his term as Treasury Secretary, 1921.

Credit: Library of Congress.

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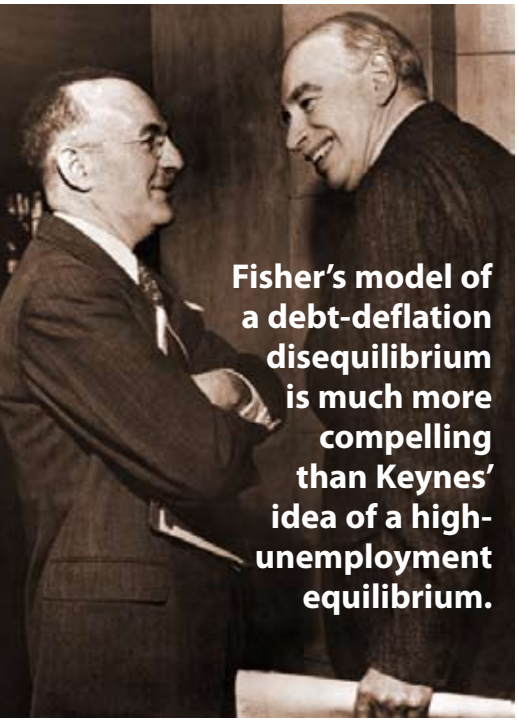
materials, and loans notwithstanding. Left to its own devices and the tepid interventions of the Hoover administration, the economic system became ever more dysfunctional—no mechanical apparatus was at work to bring the system back to any semblance of equilibrium.

Surprisingly, by 1933 Fisher had reflected deeply on the idea that the economy would quickly spring back to full employment. In a 180-degree turn, he now argued that the Depression had unleashed forces that were sending the economy ever downward. The U.S. economy of the 1920s had been built on mountains of business, farm, mortgage, and personal debt. Now deflation was creating its own momentum. The burden of that debt was growing greater and greater as incomes shrank under the relentless pressures of deflation. As farm and business income fell, an ever-larger portion of income was shifted to the financial sector to pay debts that had been contracted when prices were much higher. In short, the growing debt burden was driving farmers and businesses into bankruptcy, thereby leading to further layoffs and more unemployment. Those households that had accumulated mortgage debt or consumer debt were in the same boat. As wages fell, families could not possibly pay an ever-growing share of their shrinking income to make debt payments *that did not deflate with the rest of the economy*. This was Fisher's all-important debt-deflation theory; it explained how a situation of over-indebtedness would lead to declining overall demand as the economy now favored creditors over debtors.



Fisher's model of a debt-deflation disequilibrium is much more compelling than Keynes' idea of a high-unemployment equilibrium.

John Maynard Keynes (right), with Assistant Treasury Secretary Harry Dexter White, at the inaugural meeting of the International Monetary Fund, Savannah, Ga.,1946.

Credit: IMF.

In neoclassical theory the fact that more of the total income was now shifting to creditors should not have impeded the economy's recovery. What debtors no longer spent, went the argument, creditors would now spend. This symmetrical model, however, just did not apply in the real and non-mechanical world of economic institutions. Banks and other creditors found that their income from debt repayments gave them greater power as money *increased* in value while wages and all other components of the economy *declined* in value. But the banks did not then lend out more money because they were fearful of the endless chain of bankruptcies the Depression had unleashed. They wanted to hold lots of funds in reserve against future losses. And to the degree that the income from the creditor institutions was passed through to managers, owners, and shareholders, these well-off groups were less likely to spend the additional income than were the workers, farmers, and owners of small- and medium-sized businesses who suffered growing losses. In sum, shifting a greater share of total income into the hands of wealthy creditors served only to push the economy further downward because (1) banks hoarded funds against future losses, (2) businesses seeing low and falling sales refused to take on any more debt, and (3) the rich did not put much of their new, more powerful, dollars back into the spending stream. Deflation had a supercharger effect—downward movement in the macro-economy unleashed powerful forces that led to further, perhaps accelerating, downward movement.

Today, Fisher is far less well known than another economist who took on neoclassical economics orthodoxy in the 1930s, John Maynard Keynes. Keynes challenged the neoclassicals with his interpretation of how total final demand determined the level of production and employment. He sought to show that the macro-economy could be caught up in a "special case" wherein equilibrium was established at very high levels of unemployment. In this situation, economic forces were aligned and balanced in a way that—whatever the rate of unemployment and excess capacity—the economy could do no more than simply reproduce itself year after year. Monetary policy would not revive the economy. Keynes famously urged massive government intervention to "prime the pump," thereby inducing the economic system to return to its normal state.

Yet Fisher's model of a debt-deflation disequilibrium is much more compelling than Keynes' idea of a high-unemployment equilibrium. Inflation-adjusted GDP fell by 9.5% from 1929 to 1930, and then fell by 7%, 15%, and 2.7% in the following three years. This was a downward spiral, not an equilibrium process.

The Structural Problem

The Great Depression signaled a moment when the U.S. economic system had met with structural barriers to its own expanding reproduction. The period from the 1870s to the 1920s saw the birth and consolidation of the giant corporation and the end of competitive capitalism based on small units of production, as economist Richard DuBoff has documented. By the 1920s, competitive capitalism could be found only in the minds of economists and in the texts and lectures they fed to generations of misinformed students. Along with the consolidation of a new structure of monopoly capitalism, the dynamic engine of the system had shifted from the production of producers' goods to the production of consumer durables such as washing machines and radios. The 1920s were fueled above all by exploding consumer demand for autos and their backward linkages to the oil industry, the auto parts companies, machine-tool firms, mining corporations, and producers of other raw materials such as rubber.

But growing income inequality, of a magnitude precisely equal to that which occurred in the run-up to the financial meltdown of 2007, undermined the future growth of the U.S. auto industry. (The top 1% in the household income distribution received an incredible 24% of all income in both 1928 and 2007.) Investment in the auto industry peaked in 1926, after which stagnating demand forestalled the building of more auto plants. Weak-to-nonexistent union power was a major reason why the economy began to totter both in 1927 (and again in 2006) when the housing boom peaked—a crucial matter ignored by both Fisher and Keynes.

Deeply embedded in the popular consciousness is the idea that the stock-market crash of 1929 *caused* the depression of the 1930s. The same was true of the most severe 19th century downturn: conventional accounts of the Panic of 1873 claimed that the depression was due to the collapse of the largest financier of the time, Jay Cooke & Company, causing losses to reverberate through the financial centers, particularly New York. Similarly, many of today's commentators pin the current economic crisis on *financialization*—the growing weight of the finance, insurance and real estate sector—which, the story goes, led to Ponzi finance, excessive leverage and the collapse of Bear Stearns, Lehman Brothers, and (effectively) A.I.G.

In short, the depressions of 1873 and 1929, and the borderline depression that began in 2007, are all widely assumed to have been caused by the alchemy of financial wizards. Those who take this view generally restrict their focus to the complex world of finance, without giving due attention or weight to underlying structural changes that have resulted in unsustainable tensions among the non-financial foundational components of the economy.

In recent years, the pace of structural change has been determined by (1) the realignment of capital-labor relations resulting in the effective de-unionization of the U.S. economy; (2) the outsourcing and offshoring of millions of jobs coupled with the threat of such actions, which has caused a dramatic tilt in the distribution of national income toward capital (partly buried as the greater part of the "salary" portion of the largest national income category, "wages and salaries"); (3) the subsequent delinking of productivity increases from wages, leaving a growing mass of profits to be redirected both to conspicuous consumption on a scale never before imagined and to predatory financial gamesmanship. In brief, a profound process of capital restructuring has taken place, giving rise to a new system of globally integrated production that has left the U.S. working class puzzled, powerless, and leaderless.

A Fisher Forecast?

According to the general perspective of the economics profession, depressions are a thing of the past: clever monetary policy and/or dynamic fiscal policy can reverse any downturn. Through massive injections of cheap credit and/or some combination of tax cuts, automatic countercyclical outlays (such as unemployment benefits), and discretionary expenditures (including especially those that boost the income of military contractors), federal policymakers can induce a recovery. Since 2007 the United States has followed exactly this prescription, and federal deficits will average approximately 10% of GDP in 2009, 2010, and 2011—more than double President Roosevelt's peak New Deal deficits in 1935 and 1936.

We can credit these massive interventions with curbing the forces unleashed as a result of the overcapacity problems, but they have not addressed the Keynesians' prime focus: employment. The U-6 unemployment rate—the best measure of the health of the labor market—includes the officially registered unemployed and also those who are working part-time but are seeking full-time employment and those "discouraged" workers who are not actively

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seeking employment but would if they thought jobs were available. The U-6 rate started to climb in late 2007 and had already hit 10.6% in 2008. It then soared on to 16.3% in 2009 and 16.7% in the first six months of 2010. If we take these data at face value, the U.S. economy is in a borderline depression, and one that is deepening.

Of course, unemployment is not the only factor. GDP has grown at an anemic annual rate of 3.2% in the past four quarters. Recoveries entail at first merely the reestablishment of previous levels of output, yet third quarter 2010 GDP (constant dollar) was still $86 billion below the last peak, in the fourth quarter of 2007. In the most recent nine-month period (fourth quarter 2009 through second quarter 2010) much of the growth has been in inventories, not in final demand. In fact, in the second quarter of 2010 final demand grew at an annual rate of only 1.3%.

Women working in war production, Aluminum Industries, Inc., Cincinnati, Oh., 1942.

Credit: Alfred T. Palmer, Office of War Information. Public Domain.

The $64 question is this: what will happen in 2011 when the Obama administration's fiscal stimulus will rapidly drop off? Even though federal fiscal stimulus in 2011 (which began October 1, 2010) will be large, it will be partially counteracted by declining spending on the part of most state and local governments. The total effect of massive cuts at the state and local level in 2011 will be to *withdraw* funds in relatively labor-intensive areas such as education and health care. An estimated 500,000 local government employees are scheduled to be terminated in 2010 and 2011. To this group should be added another 900,000 public and private sector jobs currently sustained by the 34 states that will face the need to trim their budgets to accommodate falling tax revenues in fiscal years 2011 and 2012. The roughly 1.4 million threatened state and local layoffs could eventually have a much larger impact, potentially forcing twice that number or even more into unemployment. Even with the $26 billion in emergency one-year funding that passed the Congress in 2010, sizeable state and local layoffs and wage cuts will occur in fiscal year 2011. In September local government layoffs hit their highest rate in over 30 years.

In addition, a large amount of the federal deficit in 2011 (including the net $55 billion of new stimulus due to the drop in Social Security taxes in December 2010) will, once again, bleed away as imports. That is, a significant portion of government stimulus funds received by households via unemployment insurance payments, food stamps, tax cuts, jobs saved in construction, etc., will be sent abroad to pay for imported consumer goods, oil, machinery and equipment. Further, the major share of the federal debt (54% of marketable treasury bonds in December 2009) is now owned by foreigners—so most tax payments for interest must be shipped abroad to service the debt accumulated in past years.

Major corporations have continued to avidly restructure their production processes, laying off workers right and left. For example, Ford's North American division posted a huge second-quarter 2010 profit of $1.9 billion—this after cutting its labor force by 50% and seeing its revenue drop by $20 billion since 2005. Even the touted expansion of the Louisville Ford plant in 2011 will generate only a few hundred net new hires making only $14 per hour—half of the average pay of previously hired workers. The new corporate formula is higher profits from lower sales and little investment. Real Gross Investment (new capital spending plus replacement spending for worn-out equipment, adjusted for inflation) fell by 30% from the third quarter of 2007 to the first quarter of 2009. In the second quarter of 2010 overall investment was still 17.4% below the level achieved in late 2007.

Investment, then, is weak, while profits in the third quarter of 2010 reached a 60-year record high of $1.66 *trillion*. This profit rate rose by almost 30% from its recent low in the first quarter of 2008 through the first quarter of 2010. Indeed, the profit rate is now so high—thanks to the great squeeze on workers—that it exceeds the level achieved in the third quarter of 2007 by about 13%. *If* these bloated profits were channeled back into investment, then the economy would have a tendency to recover. But they are not. Corporations are taking their profits and sitting on them—cash holdings are at their highest levels since the early 1960s.

Across the United States, wage cuts have become a front-line strategy. A 2010 survey of U.S. cities found that 51% were either cutting or freezing existing wages. At General Motors, all new hires make one-half the rate of senior production workers. Even worse, this two-tier wage system is rapidly becoming a three-tier system where jumps in demand are being met by a new cadre of "permanent" temporary workers—known as "casuals"—non-unionized workers with no benefits. In some cases casuals make up more than 25% of the peak workforce, and they are paid only 75% of the second-tier wage. As federal government spending stalls out in late 2010, as the rich pull back from their recent spending binge, as corporations pocket much of their fat profits instead of plowing them back into expanded capacity, as wages stagnate or fall, as most state and local governments retrench further, as the new Republican-dominated congress contemplates federal program cuts in 2011, and as the meager additional net stimulus from the December 2010 Social Security tax cut is considerably shrunk by household debt repayments and the purchase of imported consumer goods, it is very difficult to foresee a continuation of what is conventionally called a "recovery".

Keynesians assume that massive federal stimulus will somehow cause the forward gears of the capitalist system to mesh—but they do not explain how or why. So far, Keynesianism has gained no forward traction, although it has prevented a backward slide. This stalemate is not unprecedented. The New Deal was largely stuck in place after 1936 because of the political resistance of the captains of industry and finance to further and larger deficits. Likewise, political opposition to further huge deficits likely explains some of the current situation of stagnation and slippage. But when World War II spending ended the Depression, more was involved that just spending. The war industries created a new industrial base that generated a host of major technological changes, for example in petrochemicals, aircraft engineering, and plastics. The war broke a power logjam and financed the industrial restructuring of the U.S. economy.

Since 2008 the government has prioritized policies to push the profit rate up, thereby benefiting the top 5 million (3.7%) of all households, those with incomes above $250,000, while shrugging off the plight of the working and middle classes and the structural problems that have created the current impasse. Millions in these classes are now caught in a Fisher-style debt trap, with their incomes flat or falling and their debt-to-income ratios remaining extremely high. For most families, wealth continues to shrink: housing values lost an additional $1.7 *trillion* in 2010, with the largest proportional declines being felt in working-class neighborhoods. Aside from some largely symbolic gestures, neither the Bush nor the Obama administration's stimulus efforts have addressed the drag effect that Fisher highlighted. This has stalemated the stimulus programs and the easy-money efforts of the Fed, leaving the majority in the United States in a condition of crushing economic precariousness. D&S

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SOURCES: Alan Blinder and Marc Zandi, "How the Great Recession was Brought to an End" (July 27, 2010); Bureau of Labor Statistics, BLS Data Series: Labor Force Statistics, Table A-15, "Alternative Measures of Labor Underutilization"; Susan Carter et al., *Historical Statistics of the United States*, Cambridge University Press, Tables Aa9-14, Ba4218 and Ca208-212 (2006); Lester Chandler, *America's Greatest Depression*. New York: Harper & Row (1970); Richard DuBoff, *Accumulation and Power: An Economic History of the United States*, Armonk, New York: M.E. Sharpe (1989); Rendig Fels, "American Business Cycles 1865-1879," *American Economic Review* v. 41 no. 3 (June 1951); Irving Fisher, "The Debt-Deflation Theory of Great Depression," *Econometrica* v.1, no. 4 (October 1933); John K. Galbraith, *The Great Crash*, Houghton Mifflin (1954); Steven Greenhouse, "More Workers Face Pay Cuts, not Furloughs," *New York Times* (August 8, 2010); Nicholas Johnson et al., "An Update on State Budget Cuts," Center on Budget and Policy Priorities (August 4, 2010); J. M. Keynes, Economic Consequences of the Peace, New York: Harcourt, Brace & Howe (1920); J. M. Keynes, *The General Theory of Employment, Interest and Money*, New York: Harcourt, Brace & World (1936); David Leonhardt, "Biggest Local Cuts in 30 Years," *New York Times* Economix blog (October 8, 2010); Cathrine Rampell, "Recovery Slows; Outlook on Jobs Grows Dimmer," *New York Times* (July 31, 2010); Cathrine Rampell, "Third Quarter Was Record for Profits," *New York Times* (November 24, 2010); Motoko Rich, "Wealthy Sector of Buying Public is Cutting Back," New York Times (July 17, 2010); Emanuel Saez, "Striking it Rich," (August 5, 2010); William Selway, "US Cities and Counties Poised to Cut 500,000 Jobs," (July 27, 2010); Nelson Schwartz, "Industries Find Surging Profits in Deeper Cuts," *New York Times* (July 26, 2010); Louis Uchitelle, "A White House Campaign for Factories," New York Times (September 10, 2010); Louis Uchitelle, "Unions Yield on Pay Scales to Keep Jobs" *New York Times* (November 20, 2010); Hui-yong Yu and John Gittelsohn, U.S. Home Values to Drop by $1.7 Trillion This Year, (December 9, 2010); U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, Table 3-b (2010); U.S. Treasury, "The Case for Temporary 100 Percent Expensing: Encouraging Business To Expand Now by Lowering the Cost of Investment" (October 29, 2010); Thorstein Veblen, "Why is Economics not an Evolutionary Science?" in *The Portable Veblen*, Max Lerner, ed., New York: Viking (1948), reprinted from the *Quarterly Journal of Economics*, (July 1898); Francis Warnock, "How Dangerous Is U.S. Government Debt?" *Capital Flows Quarterly* (Council on Foreign Relations, 2010).