Loose Credit and Low Wages: A Re-examination of US Postwar Economic History in Light of the Recent Recession.

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Introduction

The protracted nature of the current global economic downturn, beginning in late 2007 with the crash of the US credit markets and continuing on into today, suggests that a wider range of policy responses are now required by the international community to get the global economy back on an upwards trajectory of growth. Orthodox economics, with its disproportionate bias towards the supply-side of the economic equation, has proved extremely ineffectual in addressing the multitude of problems associated with the current global recession. In particular, the apathetic approach encapsulated by the neo-classical position, which asserts that the 'free market' should be left alone to generate a solution to any economic downturn, has proved a highly costly ideological position for the global economy to follow. Fortunately however, in policy-making circles, a slight move away from the debilitating neo-classical supply-side position is now under way, giving rise to proactive policies that do not wait for the market to 'inevitably' fix itself.

It is now recognised by the policy-making community that a degree of governmental oversight is required over the financial markets in order to prevent irrational exuberance from taking over and becoming a systemic problem. This new policy approach is centred on the need to institute minimal safeguards in order to prevent a massive build-up in credit and credit-expanding financial instruments, which have been attributed to causing the crash of the US credit markets in late 2007.

Conventional policy is concerned with the initiation of light regulation over financial market activity, in order to regulate liquidity and prevent excessive leverage within the financial system. It is recognised that the expansion in credit over the last decade was systemic and not the work of a few reckless individual institutions. Conventional policy-makers argue that it was the considerable expansion of credit and its related instruments during the decade of the 2000's that produced the unsustainable credit bubble that crashed in late 2007, leading to today's global recession.

However, where the contemporary policy response comes up short is in providing an answer to the reasons why expanded access to credit was relied upon to such a disproportionate degree to stimulate economic growth in both the United States and the global economy at large throughout the decade of the 2000's. The answer to this question requires a wider political-economy approach, with an historical analysis that extends much further than the immediate years preceding the crash. It is this wider historical analysis that encompasses the body of this paper.

The contemporary policy response also suffers from the fact that it is a mere re-tinkering of the orthodox supply-side position. It is argued by contemporary policy-makers that top-driven financialised growth is an efficient and effective economic platform, which only led to a severe contraction in late 2007 due to the absence of minimum regulation to guide the financial markets in the right direction. The conventional policy position therefore does not view the system of financialisation per se at fault; rather it argues that the absence of sufficient regulation prevented the system from achieving the positive outcomes espoused by the neo-liberal position. It is argued that the few flaws in the financialised system, once offset by the required regulation, should enable economic growth to occur and the ideals of the neo-liberal economic position to bear fruit in material growth.

In contrast, this paper argues that if a sustainable and effective recovery is to be generated out of the current recession, then far more than just a light tinkering of the orthodox neo-classical position is required. While the conventional approach is able to mitigate some of the immediate symptoms of the recent crash, a radical move away from the financialised system of growth inside the United States is urgently required in order to effectively address the root cause of the current global economic crisis. For this to be realised, it is vital that the scope of the current debate is widened considerably, to include alternative positions that do not conform to the neo-liberal consensus.

The postwar political economy of the United States shall be re-examined in this paper in an effort to provide an alternative account of American economic history from that which has been provided by the predominant paradigm of neoliberalism. This alternative reading will be heavily based on the Keynesian tradition and will place its central focus upon conditions of demand in order to counterbalance the orthodox position with its disproportionate emphasis upon factors of supply. The nature of this undertaking means that the paper is substantially broad in its analysis. It therefore must be stated in advance that this paper is by no means attempting to undertake an exhaustive account of the entire period of US postwar economic history. Rather its aim is to widen the scope of contemporary economic debate by revealing that the chain of causation for the current recession stretches back far further than the conventional account has been willing to recognise in its policy analysis.

It is imperative that the scope of the contemporary debate is widened to include the historical period of the 1950s and 1960s, leading up to the decade of the 1970s. This is essential as the economic situation of the 1970s has often been employed as an empirical justification for the practical implementation of neoliberal economic policies from the 1980s on. This so-called ‘empirical’ justification has spawned such debate-defying statements as the T.I.N.A. slogan (There Is No Alternative) and other such positions, whose politicisation has dramatically confined the scope of economic debate within policy-making circles to the paradigm of neoliberalism. It is therefore necessary to go back and re-examine American postwar economic history from an alternative perspective, in order to determine whether in fact there was an alternative to the adoption of neoliberalism in the 1980s. This historical re-examination is essential for the contemporary policy debate, for if it is uncovered that there was an alternative to neoliberalism in the 1980s, that also suggests that there is an alternative to neoliberal policies today. This therefore means that the contemporary debate should include other paradigms of political economy, in order to ensure that we do not repeat the mistakes of the past.

This paper posits as its central thesis the position that the substantial expansion in credit within the United States was employed as a necessary substitute to cover the dearth in global aggregate demand that has existed over the last thirty years. For the global economy taken as a whole, supply far outstrips demand. There are considerably more producers selling goods into the global economy than there are consumers who are able to purchase these products. Mass consumption, which the mass production of industrial capitalism is ultimately dependent upon, has not been extended onto the international stage alongside the globalisation of industrial production. This has meant that the consumer markets of the developed economies, especially that of the United States, have been overwhelmingly relied upon to purchase the goods produced by the growing number of exporting nations within the global economy. This disproportionate dependence upon American consumers has in turn inspired an expansion in credit inside the United States domestic economy, effectively enabling its consumers to continue to purchase the goods produced by the global economy at large.

Expanding access to credit to these consumers has received an additional impetus from the current microeconomic formula of reducing commercial operating costs – including labour – to as much as possible. Often this microeconomic strategy involves outsourcing production away from workers who were once paid a middle class income in a developed economy to the sweatshops of developing nations, where workers are only paid at a subsistence level and are thus unable to purchase the goods that are manufactured by their labour. This has resulted in a further contraction in global aggregate demand, leading to an increased dependence on expanded credit to stimulate economic growth within both the United States and the global economy taken as a whole.

It is therefore clear that if regulation is to be implemented in order to curtail the expansion of credit, as suggested by the conventional policy response, then wider measures need to be devised that enable global aggregate demand to grow in order to replace the stimulus effect that expanded credit access has provided in recent years. Fortunately there is an historical model for such a capitalist economy, found in the structure of the American economy throughout the 'Golden Age' period of the 1950s and 1960s. This historical model shall encompass the focus of the first chapter of the thesis.

The application of neoliberal supply-side policies from the 1980s on has often been justified on the grounds that the Keynesian inspired economic structure of the 1950s and 1960s generated a number of economic inefficiencies that later led to the problems experienced by the American economy during the 1970s. Chapter Two of the thesis challenges this neoliberal consensus by re-examining the economic situation of the 1970s. In particular, the chapter re-examines the relationship that existed between the domestically oriented economic structure of the United States with that of the increasingly integrated international economy from the 1970s on.

Chapter Three will detail the ways in which the practical application of supply-side policies further contracted the conditions of real aggregate demand inside the United States economy, thus exacerbating the underlying problem of the US economy in the contemporary period. The fourth and final chapter examines the ways in which credit was expanded inside the United States, along with the dependence of the US economy on this expanded credit in order to generate economic growth. The paper will conclude by exploring alternative avenues to economic recovery from that which has remained the convention over the last thirty years.

Chapter 1: Rediscovering the Golden Age

Introduction

The fallout from the 2008 crash of the US financial sector is threatening to have grave and long-lasting ramifications for both the United States and the global economy at large. With its financial sector mired in deep recession, the US economy needs to find a way to achieve economic growth that is not disproportionately centred on the performance of its companies on the financial markets. This is essential if the country wishes to avoid the trappings of the current crisis being exacerbated into a debilitating depression of global dimensions. Fortunately there is an historical precedent for such a system of economic growth. This is to be found in the productive system that encompassed commercial relations within the American economy during the 1950s and 1960s.

The twenty-five year period following the culmination of the Second World War till the beginning of the 1970s will be analysed in this chapter, as a means to provide an empirical example of an economy where growth is based on productive performance, not financial asset appreciation. The chapter will begin by analysing the conditions found within the US economy following the culmination of the Second World War. It will examine the industrial make-up of the US economy and analyse the influence this had on the system of economic growth that developed in the United States during this timeframe. The chapter will then analyse the role of the US government in encouraging the development of an economy where growth was primarily centred on the production of advanced technological items.

The next section will examine the normative regime that developed amongst the dominant manufacturing corporations during this period. It will be argued that this normative regime was developed by the private sector as a means to maintain the essential economic conditions that were required for the production of advanced commercial technologies. The analysis of this normative regime will be based on academic literature from this period. Notably, the paper will adopt the term the 'planning system', penned by the economist John Kenneth Galbraith, as a means to analyse the productive system of economic growth during this period.

As shall be revealed in the final sections of the chapter, the kind of economic growth that was achieved by the American planning system was one that was primarily based on knowledge and innovation. It was a capitalist system of economic growth that utilised the productive power of the country's public sector, along with providing an essential role for organised labour within its commercial system. Moreover it was one that reduced industrial corporations' dependence to as much as possible on the potentially disruptive financial sector.

Thus the following analysis of the American economy in the 1950s and 1960s provides an empirical example of an economic model where growth was achieved through productive innovation rather than financial speculation. As such, this period serves as a useful contrast to the financialised economy of the United States today. It is therefore essential that this period is analysed and lessons learned from the United States' economic history, if there is to be established an effective form of capitalist growth-generation that is not dependent upon the 'trickle-down' investment of a financial sector that is currently stifled by a serious recession.

The Post-war US Economy

The years 1950 through to 1969 are now affectionately referred to as the Golden Age years of the American economy. This is an endearment enacted to describe the consistently impressive levels of economic growth that were achieved during this period. According to the scholar Robert Reich, "from the end of World War II to the mid-1970s the pay and benefits of the American workforce grew, on average 2.5 – 3 percent each year, in tandem with productivity growth. Between 1947 and 1973, real median family income doubled, as did the value of what the typical American worker produced".[1] A number of factors can be attributed to the prevalence of these highly impressive growth levels, not the least of which is the fortuitous set of economic circumstances the country found itself in following the culmination of the Second World War.

[1] Robert Reich, *Supercapitalism: The Transformation of Business, Democracy and Everyday Life*, New York: Alfred A. Knopf, 2007, P.36

Emerging as the only advanced capitalist nation to have its economic infrastructure in strong working health following the war, the United States was from the beginning of the period, placed at a considerable competitive advantage over that of the other advanced industrial economies. Indeed, while the economic infrastructure of the Western European nations had been largely decimated by the destruction of war, that of the United States had remained not only intact, but also importantly, significantly modernised by the mobilisation effort initiated during the war years.

The federal government, operating under the rubric of New Deal policies, occupied a pre-eminent position in generating the economic development that was instigated under this mobilisation initiative. In the United States, mobilisation was achieved through the awarding of government contracts to the established manufacturing corporations operating throughout the economy. This was undertaken in an effort to utilise existing infrastructure in order to quickly and efficiently engineer the armaments required for successful engagement in the ensuing global conflict. In consequence, the US government adopted the vital role of maintaining aggregate demand during the war years, providing a stable customer for the country's large corporations and thus filling the market vacuum that had opened up due to the depressed levels of consumer spending throughout this period.

Since a large number of these government contracts included a considerable R&D component, (initiated under the recognition that victory would be achieved by technological supremacy rather than sheer force) American industry underwent a considerable technological advancement during this period. In addition, the maintenance of relatively high employment levels during the war, an outcome of the government's efforts to maintain adequate aggregate demand, enabled American households to achieve a substantial level of individual savings. Thus once the war was over, sufficient liquid capital (earned cash through accumulated savings) existed within the economy to enable a consumption boom to quickly embrace the American economy. This created the conditions enabling the country's manufacturers to quickly re-orient themselves back to the civilian economy, a re-direction further facilitated through the utilisation of technological advancements developed during the preceding period. As such, recently developed technologies were utilised to innovate and redesign existing consumer goods (such as automobiles), while also enabling the manufacture of new electronic goods, marketed towards the ordinary household needs of American consumers.[2]

This development can clearly be seen in the example of the traditionally important economic sector of car manufacturers. Here, it was possible, following the "serious erosion of cars during the war and in the general forward surge of the aftermath boom… [for] automobilization, with all its multifarious ramifications, [to] once again become a major stimulus" within the American economy. In turn this generated demand for the inputs of other American industries, precipitating a massive stimulus spin-off effect.[3]

The Post-War US Corporation

With such prevailing post-war domestic economic conditions, pre-existing US corporations faced few barriers indeed to economic growth. In addition, the likelihood that new commercial competitors would develop to contest their dominance within their respective fields was significantly reduced. This was namely due to the massive size of the dominant corporations, who were accumulating a vast store of capital and resources through the consumption-driven boom underway during that time. This thus provided them with the means to withstand any attack by a newcomer to their industry.

Furthermore, their market position had been symbolically strengthened by the establishment of recognised brands by the dominant companies. Through advertising, brand identification was a factor rapidly increasing in influence, especially with the introduction of the medium of television in the 1950's. On top of all this, the vast sums of capital required to acquire the type of technology utilised in the production undertaken by the dominant corporations, effectively precluded the possibility of a new firm entering an established industry on a competitive footing.

The lack of serious competition for the dominant corporations was further compounded by the near-total absence of foreign competitors vying for market share within the US domestic economy. As previously mentioned, the main international rivals of American industry were temporarily incapacitated by the massive destruction of infrastructure during the Second World War. Thus with virtually no foreign

[2] Paul A. Baran and Paul M. Sweeny, *Monopoly Capital: An Essay on the American Economic and Social Order*, New York: Monthly Review Press, 1966, P.176
[3] Ibid, P.236

competition to contend with, and the prospects for the emergence of commercially viable domestic competitors markedly slim, what tended to develop within each established industry was the emergence of three or four large firms dominating each industry, typically with one giant corporation enjoying the largest market-share.

The Role of Government in the Post-War Economy

In the post-war Truman administration, there was significant debate on the role of government and how its policies would be employed to influence the subsequent character and development of the US economy. It was decided by the administration that rather than place limits on the growth of large corporations and thus engineer more competition within the economy (a position with its precedent in the break-up of Standard Oil in the nineteenth century and the ensuing anti-trust movement), government would utilise the enormous economic power of the giant corporations and direct this in a manner that was both productive and profitable for the nation's economy as a whole. As can be seen, this was largely in keeping within the direction that developed during the war years, where the government would ensure that economic gains would be distributed in a fairly equitable fashion, following the directive of the New Deal policies, while further ensuring a stable customer for a large number of corporations via the granting of governmental research contracts, a position that was progressively able to be facilitated under the imperative to maintain technological advancement. Indeed the prerogative to maintain technological supremacy derived increasing importance during this period, as the demands of the Cold War quickly occupied the political objectives of the succeeding administrations.

Thus while military spending was high during the years of the Cold War, a large chunk of this government spending was distributed to the private sector in the form of contracts for the development of advanced technology. An example of this can clearly be seen with the sensitive technological sector of nuclear energy. Here, while the "Atomic Energy Commission still controlled much of atomic power, major research was carried on by such firms as Westinghouse, General Electric, and North American, while privately owned utilities accounted for most of the commercial uses of atomic energy". Likewise, with the race to space involved with the Government department of NASA, "space exploration was initiated and carried on by the government". But this was largely achieved "through large contracts given to private firms such as McDonnell Corporation, North American, Litton Industries, Grumman and many others".

Moreover, the "use of satellites for communication, first explored by government agencies, was carried out by a government-created but private firm, Communications Satellite Corporation".[4]

All of these examples point to the vital role of the government in creating the conditions conducive for technology-centred corporations to engage in the otherwise risky endeavour of innovative research in the development of advanced technological equipment. This development experience further provided them with the means to adapt these technologies into commercially viable household products. For example military research into radio heat waves was largely responsible for the technology behind the microwave oven.

A unique feature of the political-economy of post-war America was the welfare orientation of the system, whereby benefits were primarily distributed through the private sector, operating as conditions tied to employment in one of the large corporations dominating the country's industrial landscape. This indeed signified a unique development, especially as it occurred in the era of the welfare state, a development that encompassed the vast majority of other advanced capitalist nations during this timeframe. This is not to say that there was no welfare state development at all within the American economy. Indeed the policies instituted under the New Deal of the 1940's heavily argue against any such assertion. Nevertheless, it is arguably clear that welfare state development in the succeeding post-war period was significantly stifled, when compared to that of the other advanced capitalist nations. This was an historical outcome that was enabled by the fortunate economic conditions the country's corporations encountered in the immediate post-war period. For as they enjoyed high aggregate demand levels, private firms could easily afford to pay for such benefits, utilising them as a means to attract the most productive workers. In addition, the high employment levels prevalent during this period ensured that private sector distribution would reach the great majority of American citizens.

Thus the mixed system that developed in the United States was something of an anomaly, when compared to that of the other advanced capitalist countries. Instead of the development of a strong welfare state with the means to counter the destabilising tendencies of the open market, the United States developed a governmental system that can be more accurately depicted as a loose safety net. This key difference is clearly

[4] Robert Sobel, *The Age of Giant Corporations: A Microeconomic History of American Business* 1914-1970, Westport Connecticut: Greenwood Press, 1972, P.179

demonstrated by the fact that in the western European economies, those in wont of work received an unemployment benefit, while those in the US were entitled to an unemployment *insurance* package, largely existing as a short-term stop-gap measure, granted with the expectation that the recipient would quickly recover work, in line with the favourable employment conditions that prevailed during that period.

Nevertheless, in the absence of adequate state protection from the inherent instabilities of the market system, the private sector itself came to coordinate a rough system of normative behaviour, intended both to enhance and protect the power of the productive economy, being at the time primarily composed of manufacturing industries. This was achieved through a number of initiatives designed to shield their business practices as much as possible from the disruptive forces of the free market. It is to this interesting set of circumstances, peculiar to the US economy in the historical era of the Golden Age that we now turn.

"Co-respective Competition"

Owing to the existence of three to four large corporate firms dominating each industrial sector, with each firm occupying relatively entrenched market positions, any attempt at unilateral price reduction by any of the major firms would prove counter-productive for all concerned. For if one company lowered its price, all would be forced to follow suit, with the end result being that each company would still have the same market share, but now at reduced revenue, due to the successive downscaling of price for their product during the escalating price war. As a result, the major corporations adopted alternative means of competing for market share within their respective industries. This included "advertising, research and development of new product varieties, [and the inclusion of] extra services". During the Golden Age, these alternative methods came to constitute "the usual means of fighting for market shares". In addition, they tended "to yield results in proportion to the amounts spent on them".

The major industrial firms of the time thus engaged in complicit (yet widely accepted) norms to refrain from aggressive price reduction as a competitive strategy. This acceptance was termed "corespective competition" by the scholar Joseph

Schumpter.[5] Complicit acceptance was deemed a necessity, as any open practice of this policy would constitute illegal activity under the prevailing antitrust legislation that governed commercial relations during this period.

In order to remain under the radar of the regulating authorities, this complicit consent at tacit price coordination appeared in a number of forms. The most prevalent measure was that which was identified by the scholars Paul A. Baran and Paul M. Sweeny in their research during this period. According to these scholars, the complicit consent to roughly coordinate prices reached "its most developed form in what is known as 'price leadership'". Under this system, each firm competing within the industry accepts the price maintained by the leading firm as the prevailing price for that specific industrial product. The 'leader' is defined as "the largest and most powerful firm in the industry – such as U.S. Steel or General Motors". The others accept this price as the industry standard, an understanding reached in awareness that if it ever came to a competitive price war, the 'leader' holds the sufficient size and internal revenue to out-compete all concerned.[6]

Importantly, the system also accommodates an inducement that serves to discourage the 'leader' from engaging in any competitive price reduction strategy. This is important as the leader occupies a position that would otherwise embody a destabilising factor, which in turn would exist to deter the institutionalisation of this normative regime. This inducement involves the desire by the 'leader' to avoid any activity that could be interpreted by the courts to denote an attempt to acquire a monopoly share over a specific market. Aggressive short-term price competition, if undertaken by the 'leader', with the greatest share of resources at its disposal (and thus likely to be the sole survivor if such a strategy was followed to the full) could well indeed constitute such activity.[7]

An example of the restraint exercised by the industrial 'leaders' of post-war America can clearly be seen in the behaviour of General Motors within the automobile industry. At the time, a number of "analysts believed that General Motors set its prices so as to enable Ford and Chrysler – not to mention the smaller firms – to compete successfully. Through this approach, "General Motors tried to gain a twenty-percent

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[5] James Crotly, 'The Neoliberal Paradox: The Impact of Destructive Product Market Competition and 'Modern' Financial Markets on Non-Financial Corporations Performance' in Gerald A. Epstein, *Financialisation and the World Economy*, Edward Elgar Publishing, 2005

[6] Baran and Sweeny, *Monopoly Capital*, PP 69-70

[7] Ibid

return on equity, a higher rate than was the practice at Ford or Chrysler. Should it lower prices, the argument went, the other firms would be forced into dissolution or mergers, in which case the Justice Department would try to dismember General Motors". As a result, General Motors was able to erect a price umbrella over the market price of automobiles, "in much the same way that U.S. Steel used a similar device in Steel during the early twentieth century".[8]

It must be said that there were notable exceptions to this rule. According to Baran and Sweeny, these exceptions are "particularly likely to arise in a new industry where all firms are jockeying for position and no reasonably stable pattern of market sharing has yet taken place".[9] Typically, in newly-emerging industries, a lower-cost producer with a long-term vision will forego maximising immediate profits by instigating price reductions in order to attract new customers and thus capture a greater share of the newly emerging market. In turn, their competitors, if unable to match these reductions, are either forced out of the market, or made to submit to a lopsided merger, where they would subsequently remain the weaker party. Thus through this process, an emerging industry undergoes a formative phase, whereby the numerous firms jostling for market position all attempt to undercut each other until only a few firms are left with the sufficient resources and technological capacity - combined with a more concentrated share of market power - to withstand any war of attrition conducted through the means of aggressive price reduction.[10]

In consequence, as Baran and Sweeny point out, "at any given time there are likely to be a number of industries in the shake-down period of development".[11] This is especially true in an era conducive to the production of innovative products and advanced technology, which the immediate post-war period of the Golden Age assuredly represents. As a result, it is always possible to identify industrial sectors that do not conform to the "corespective competition" thesis of Joseph Schumpter. However, this by no means renders the theory incompatible with the economic reality of the Golden Age years. Indeed, as Baran and Sweeny persuasively argue, such exceptions "simply serve to remind us that it takes time for a stable oligopoly to emerge and for the

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[8] Sobel, *The Age of Giant Corporations*, P.193
[9] Baran and Sweeny, *Monopoly Capital* , P.72
[10] Ibid
[11] Ibid

corporations which compose it to develop an appropriate pattern of profit-maximising behaviour".[12]

The Planning System

John Kenneth Galbraith, a pre-eminent economist of the period, argued that this type of tacit price coordination was but one feature of what he coined the 'planning system'.[13] According to Galbraith, the 'planning system' was the business response to the demands associated with the development of advanced modern technologies.[14] He argued that the products produced by the immediate post-war American economy all required committed investment to develop and build, and even more still to remain advanced and hence competitive in the modern world. In this manner, the "products that define modern life – automobiles, jet aircraft, electronic power, microchips and cable television – cannot be produced except over long lead times and by the integration of vast networks of engineering talent". As a result, this type of production "requires planning".[15] In consequence, post-war modern corporations devised means to control market forces, whose volatility and hence unpredictability was not conducive to the stability required to plan out the long-term trajectory of investment in advanced technological equipment.

In characteristic Galbraith fashion, the scholar penned a word to describe the technological make-up of the post-war economy, a make-up that he argued differed markedly from the "entrepreneurial capitalist" model that prevailed during the nineteenth century. He coined the term "technostructure" to define the modern economy. This is in reference to the importance of knowledge and technological development to the growth of the economy, in contrast to the financial model of economic growth that predominated during the preceding "entrepreneurial" period.[16]

[12] Ibid

[13] It is important to note that Galbraith's depiction of the 'planning system' primarily stood as a critique against the power base of the dominant corporations of that time. However what is important for the purposes of this paper is that this commercial power base was maintained through knowledge and innovation rather than financial speculation. Furthermore corporate power was centred on the expansion of these companies' workforces rather than their downsizing as is the case under the contemporary financialised period.

[14] John Kenneth Galbraith, *The New Industrial State*, Princeton: Princeton University Press, 2007, P.319

[15] James Kenneth Galbraith, 'Forward' in John Kenneth Galbraith, *The New Industrial State*, P.xi

[16] John Kenneth Galbraith, *The New Industrial State*, (2nd ed) New York, New American Library, 1972, P.80

The "classical entrepreneur" identified by Galbraith, refers to the individual owners of large firms in the nineteenth century, individuals such as Henry Rockefeller of Standard Oil, or Andrew Carnegie of U.S. Steel. Such industrial identities attained their fortune from financing mergers and acquiring smaller businesses, along the way accumulating a vast personal commercial empire. Sweeny and Baran employ the term "Tycoon" to describe this entrepreneurial individual. According to the authors, a Tycoon's "primary interest lay in capital gains, made through buying securities cheap and selling them dear, an objective which could be promoted at times by building up a company and at other times by wrecking it".[17] Thus the primary source of wealth for the nineteenth century class of capitalist was through finance, with the productive business operating as a secondary vehicle, providing the collateral both to borrow off, and also as a means to achieve financial gains through the enlargement of the capital stock via the process of mergers and acquisitions.

According to Galbraith, in reference to the twentieth-century period in which he was writing, the capitalist entrepreneur "is a diminishing figure in the industrial system".[18] This was because in the post-war period, it was sophisticated technological production, not financial accumulation, which came to constitute the dominant source of wealth-generation within the American economy. Galbraith argued that the primary source of strength of modern corporations lay in their ability to organise production on a large scale. Hence by exploiting their size and enormous resources, corporations could largely control inputs and eliminate market variables. By doing so, they were effectively enabled to engage in long-term patterns of planning and investment. Thus in contrast to the financial source of corporate power in the age of entrepreneurial capitalism, in the post-war period "[p]ower has passed to a new factor of production. This is the association of men of diverse technical knowledge, experience or other talent which modern industrial technology and planning require".[19]

Clearly then, economic competition based on advanced technology requires far more personnel input than the financial funds of a wealthy industrialist. In the Golden Age Corporation, human organisation "extends from the leadership of the modern industrial enterprise down to just short of the labor force and embraces a large number of people and a large variety of talent". It is therefore "on the effectiveness of this

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[17] Baran and Sweeny, *Monopoly Capital*, P.41

[18] Galbraith, *The New Industrial State*, (2nd ed), P.58
[19] Ibid

organization, as most business doctrine agrees, that the success of the modern business enterprise now depends".[20] The power of organisation was able to achieve immense productivity gains in the corporate system of the Golden Age. Galbraith argued that the "real accomplishment of modern science and technology consists in taking ordinary men, informing them narrowly and deeply and then, through appropriate organization, arranging to have their knowledge combined with that of other specialized but increasingly ordinary men. This dispenses with the need for [individual] genius".[21] It was thus through this effective organisation, that Golden Age Corporations were able to harness their productive power, generating gains for the economy as a whole.

Baran and Sweeny similarly testify to the redundancy of the entrepreneurial capitalist during this period. They however take on a more conservative approach than Galbraith, arguing that financial entrepreneurs were still able to operate during this period , citing the "long inflation of the 1940's and 1950's" as generating "a whole crop of promoters and operators conforming exactly to the sociological type of the Tycoon". Nevertheless, they admit that such types "operate around the periphery and in the interstices of the American economy, and they are looked down upon with a mixture of disdain and contempt by the *real* big businessmen of today, the managers of the giant corporations".[22] They thus conclude that in contrast to the entrepreneurial capitalist of the nineteenth century, whom they describe as an "individualist", merely preoccupied with "self-enrichment"; the "modern manager [of Golden Age Corporations] is dedicated to the advancement of the company: he is company man".[23]

Finance in the Post-war Period

In order to isolate investment from the instabilities inherent to the financial marketplace, post-war corporations utilised their growing internal revenue earnings as the principal source of productive investment. According to Galbraith, the move to internally-generated investment embodied a significant transformation in the type of capitalism practised within the United States. The importance Galbraith attributed to this development is clearly demonstrated in his assertion that "[i]t is hard to overestimate the importance of the shift in power that is associated with availability of

[20] Ibid
[21] Ibid, P.61
[22] Baran and Sweeny, *Monopoly Capital*, P.43
[23] Ibid, PP 42-43

such a source of capital". Indeed, Galbraith went so far as to argue that "[f]ew other developments can have fundamentally altered the character of capitalism".[24]

In their work, *Monopoly Capitalism*, Baran and Sweeny identified the process whereby post-war corporations were able to limit their obligations to the financial sector:

> Most large companies have a target dividend payout rate which remains remarkably constant over long periods of time (fifty percent seems to be the most common figure). When profits rise, however, they do not immediately adjust dividends to maintain the target rate. For example, if a company has been earning \$2 a share for some time and is paying out a dividend of \$1, and if earnings then rise to \$4, the dividend will be raised to \$2 not in 1 year but over a period of several years. In the meantime the actual payout rate will lag behind the target rate. If this pattern is adhered to - and there is every indication that it is a deeply rooted aspect of corporate behaviour – it follows that a continuous rise in earnings would be accompanied by an increasingly continuous decline in the payout rate.[25]

Due to the fortuitous economic conditions of the period, combined with the pay-offs associated with long-term planned investment, American firms increased their earnings considerably in the ensuing years and thus reduced their dependence on the financial markets significantly. For example, from "1954 through 1969, there was only one year in which as many as three of the hundred largest corporations lost money. In six of these sixteen years, all of the one-hundred largest showed profits. Similarly, in eight of the fifteen years from 1955 to 1969, all of the fifty largest merchandising corporations – Sears, Roebuck, A&P, Safeway et al – made money. In only one year of the fifteen did as many as two make losses".[26]

In consequence, the character of the US share-market was fundamentally different to the version that dominates economic relations today. For the duration of the period now known as the Golden Age, the "stockmarket was never an important source of corporate finance in the United States". It was primarily used as "a market where enterprises could cash out, trading control of illiquid equipment and structures for money, and households could store value over long periods". As a result, "almost all

[24] Galbraith, *The New Industrial State*, (2nd ed), P.81
[25] Baran and Sweeny, *Monopoly Capital*, P.88
[26] Galbraith, *The New Industrial State*, (2nd ed), P.82

stock was owned by individuals and held for long periods; stock turnover was quite low" and, most importantly for the arguments of this paper, corporations were not required to "disgorge earnings to financial markets each quarter, forcing them to compete with other firms and individuals to get them back".[27]

A burning question comes to mind, however, when analysing the prevalence of the planning system in the Golden Age period: why did the financial markets - an economic sector formerly of prime importance to the American economy - accept its substantially reduced role in the structure of the post-war system? One major reason of course, is the widespread elimination of financial wealth involved in the bankruptcies of the depression years of the 1930's. Understandably, those financial institutions remaining at the beginning of the post-war period, took a considerably more conservative approach to the one that had prevailed during the interwar years. As a result, individual entrepreneurs now found it substantially more difficult to borrow the capital required to embark on a course of buying up business in order to acquire extreme levels of personal wealth.

Galbraith provides an additional explanation for the trend towards productive-generated growth (as opposed to financially-generated growth) in the immediate post-war period. Galbraith argues that the level of technical expertise and specialised skills involved in the organisation and production of modern corporations significantly limited the ability of financial interests to interfere in the governance of these enterprises. For example, Galbraith reasoned that the "country banker, out of his experience and knowledge of the business, can readily interpose his judgement, as against that of a farmer, on the prospects of feeder cattle – and does. [However n]ot even the most self-confident financier would wish to question the judgement of General Electric engineers, or product planners on the technological sophistication of products".[28]

With insufficient knowledge of technical processes, bankers and shareholders played only a passive role in corporate governance. Their lack of any real control can be seen in Galbraith's somewhat sarcastic depiction of the typical annual Board of Director's meeting during this period.

> They [the Board members] are presented with handsomely printed reports, the preparation of which is now a specialized business. Products and event plants

[27] Crotly, 'The Neoliberal Paradox', PP 87-88
[28] Galbraith, *The New Industrial State*, (2nd ed), P.80

> are inspected. During the proceedings, as in the report, there are repetitive references to *your* company. Officers listen, with every evidence of attention, to highly irrelevant suggestions of wholly uninformed participants and ensure them that these will be considered with the greatest care.[29]

Galbraith concludes his summarisation of these standard proceedings by ascribing the "annual meeting of the large American corporation [as] our most elaborate exercise in popular illusion".[30]

Moreover, Baran and Sweeny contend that shareholders were happy to allow "the corporations in which they own stock to do the saving for them".[31] This stemmed from the wide-spread acknowledgement that the most effective means of generating a return on a long-term stock investment was by leaving that investment with the firm. This was largely in keeping with the reality of the economic system practised in America at that time, where productivity was clearly the most prevalent form of wealth-generation, as opposed to speculative financial growth. It therefore made sense for a shareholder to invest long-term and thus leave the investment in the productive hands of the corporation, the entity most equipped with the resources to engineer the greatest real returns on that investment. This by far constituted the most sensible personal investment decision during this period.

This thinking was further reinforced by the tax laws then in place. Under the then prevailing tax system, a shareholder who wished to sell all or part of his shares, would have to pay a maximum rate of twenty-five percent capital gains tax on the difference between the price of the share when it was originally purchased, and the amount that it was finally sold for. If however, the shareholder was to earn more through annual dividends, then these earnings would have to be declared as part of his annual income, and thus the stock investment would be taxed under the higher income bracket levels. Thus it made sense for investors to accept low dividend payouts during the holding of the share, under the prerogative that the money stay within the corporation, which is most able to maximise the long-term gains of the investment by utilising it in a productive purpose. In this way, when a shareholder finally decides to sell his shares, he is rewarded for his long-term loyalty by receiving a significant pay-

[29] Ibid, P.85
[30] Ibid
[31] Baran and Sweeny, *Monopoly Capital*, P.47

off from the original investment that has not been too heavily reduced by tax obligations.[32]

Knowledge, therefore, came to comprise the primary source of power for corporate America, releasing it from its traditional obligation to the financial sector. Galbraith argues that the existence of this knowledge-based source of power can be clearly identified by the development of inter-related infrastructure, providing the required inputs to fuel the engines of the modern economy. This infrastructure included the educational institutions, scientific research institutes, development centres and universities, whose existence experienced exponential growth during this period.[33]

Galbraith argued at the time that these institutions stood "in relation to the planning system much as did the banking and financial community to the earlier stages of industrial development". In the earlier entrepreneurial era, "capital was decisive, and a vast network of banks, saving banks, insurance companies, brokerage houses and investment bankers came into existence to mobilize savings and thus to meet the need". In contrast, with "the mature corporation the decisive factor of production, is the supply of qualified talent. A similar complex of educational institutions has similarly come into being to supply this need".[34]

Interestingly, Galbraith's argument extends beyond that of institutional change to incorporate a normative change of values throughout American society, largely in response to the changed character of capitalism emerging during that period. The scholar claimed that the "values and attitudes of the society had been appropriately altered to reinforce the change. When savings and capital were decisive, thrift was the most applauded of social virtues… As qualified manpower has become important… Education, instead, has now the greatest solemnity of social purpose".[35]

Because education was becoming increasingly important to the technical production of post-war corporations, the public sector – the largest provider of educated labour – became an extremely important player in the American economy. Indeed, the giant corporations of the private sector were highly dependent on the public sector as a source of qualified labour, in order to maintain the ongoing profitability of their productive activities.[36] This therefore provided another useful role for the state in the

[32] Ibid
[33] Galbraith, *The New Industrial State*, 2007, P.347
[34] Ibid
[35] Ibid
[36] Ibid, P.380

economy besides the one previously mentioned, where the state maintained demand for innovative research through the allocation of government contracts for the development of advanced technological equipment.

The Role of Organised Labour and the Public Sector in the Planning System

In fact, what stands out in the Golden Age is the highly important impact the involvement of the public sector had in capitalising on the fortunate economic conditions the United States inherited following the Second World War. By 1969, twenty-three percent of all economic activity was conducted by the state (at the federal, state and local levels of government) and one-eighth of all American workers were working within the public sector.[37] These statistics say nothing of the government's indirect involvement in, for example, supplying government contracts, or the long-term commercial spin-offs the private sector received from the government's infrastructure developments. It is thus clear that the strong economic conditions during this period were heavily dependent on the prominence of the public sector in the workings of the American economy.

Another vitally important component of the Golden Age economy was labour. It was the harnessing of the skills of the American work-force that accounted for the dramatic advances in economic productivity during this period. Labour's importance to the profitability of American corporations was reflected in the relatively high wages that were paid throughout the Golden Age period. In turn, these high wages served as an important source of aggregate demand within the domestic economy, providing the disposable income among American consumers to ensure the existence of a sufficient consumer base to sell the influx of new items and the latest advanced electronic products to.

Like all economic factors within the planning system, wage rises had to be accounted for in advance and thus taken into consideration when scheduling the investment decisions of the post-war corporations. The annual wage negotiations with the labour unions thus played an important function in ensuring that all wage increases would be coordinated in a predictable fashion, not in an ad hoc manner that modern managers could not plan or prepare for. Through this coordinating function, labour unions were an extremely important component of the post-war corporate planning

[37] Galbraith, *The New Industrial State*, (2nd ed), P.32

system. Furthermore, with the industry-wide consent to not resort to price reduction as a basis for competition, unions provided an important industrial institution in ensuring that wage increases were negotiated industry-wide. In turn, the industry-wide wage increase enabled firms to pass on the costs of the wage increase to their customers, via a mark-up in price for their product in the consumer markets. Thus through the existence of unions, no firm was put at an undue cost advantage by having lower labour costs than its primary competitors, enabling the price convention of the planning system to remain in place.[38]

The dynamics of the US economy in the twenty-year Golden Age period placed productive growth in a position of prime importance for the generation of wealth in the US economy. In the process, the role of the financial sector was heavily reduced. As the arguments of many prominent economists demonstrated at the time, this indeed embodied a fundamental shift in the US economy, as the classical formulas of the entrepreneurial era were found to be no longer appropriate to the realities of the modern economy and its investment intensive advanced production. The argument put forth by classical economics was developed during a time when

> "business enterprise was assumed to be small in relation to the market supplied. The price it received was impersonally and competitively determined by the market. So were the prices paid to suppliers. Wages were also set by the market. So was the interest on borrowed funds. Profits reduced themselves to a competitive level. Technology was assumed to be stable. Under these circumstances the ideal volume of production for the firm was externally established by the relation of costs to the market price at various levels of output".[39]

Clearly this was a model that was fundamentally different to the one that prevailed during the period of the Golden Age. Thus through this major discrepancy between the practical requirements of long-term investment in the development of modern technologies and the contrasting assumptions of (neo-)classical economics, we begin to see part of the problem of American industrial policy and economic thinking as it stands today.

[38] Galbraith, *The New Industrial State*, 2007, P.306
[39] Galbraith, *The New Industrial State*, (2nd ed), PP 46-47

Conclusion

In the search for a capitalist model where growth is not dependent upon access to cheap credit and speculative activity on the financial markets, the economic period of the 1950s and 1960s provides an insightful example of a high-road economic model where growth is instead based on high wages and the production of advanced technological equipment. The main source of aggregate demand in the United States throughout the period known as the Golden Age was generated through wage growth and increased employment. Rather than this growth being defined as inflationary and hence disruptive to the country's economic prospects, as is maintained by orthodox economists today, ongoing wage rises and employment increases provided the foundation from which economic growth was then centred upon. Growth in employment and wages provided a growth in the spending power of American consumers, enabling domestic aggregate demand to continue to grow alongside domestic aggregate production, providing a sustainable self-generating system of stable economic growth in the process.

The stability of this historical system of economic growth stands in stark contrast to the financialised system of economic relations that has predominated inside the United States over the last thirty years. The planning system was a version of capitalism that was able to achieve productive growth in a manner that was uninterrupted by the country's financial markets, as evident by the nearly twenty years of continuous economic growth that were achieved during this period. In contrast to today, where financial players attempt to predict what will happen in the future; the commercial leaders of the Golden Age planned out ahead of time what they intended to achieve into the future. Rather than rely on the 'market', they organised production in a manner that was consistent and thus were able to achieve consistent economic growth as a result. Their profitability was based on the sales of goods in the consumer markets, which through the coordinated system of industrial wage increases, was a market that continued to grow alongside the productive growth of American corporations.

Thus by relying on internal revenue to fund their productive investment, and with this revenue being derived from sales in a consumer market that was simultaneously growing through an expansion in employment and wages during this period, Golden Age Corporations reduced their dependence on the country's financial sector and as such the whims of the financial markets ceased to function as a disruption to their productive growth. Prior to the development of the planning system - as indeed is the case again today - the peaks and troughs of the financial markets had proved extremely difficult to predict, thus accounting for the series of booms and busts that then occurred and have resurfaced since. Through the power of planning and organisation however, together with the pre-eminence of productive growth as opposed to financial speculation, the planning system was able to reduce these financial uncertainties, in the process achieving a sustainable system of capitalist development.

The stability of this productive-based system was also greatly assisted by the role of the American government in the Golden Age economy. Through the provision of R&D contracts to the country's commercial enterprises, the American government ensured that there was a stable customer for this necessary research. It was these government contracts that ensured that the initial research and development stage in the production of high-tech equipment would be undertaken. In the absence of this government support, new research would prove highly risky and thus not commercially viable for the private sector to undertake. It was therefore the initial provision of government R&D contracts to the private sector that enabled a high-road economic model based on the commercialisation of advanced technological equipment to be established during the Golden Age of the American economy.

This role of the government in stimulating the conditions for advanced technological production is a factor that is notably absent from the conventional policy response to the current recession. The prescribed role for the American government in the conventional policy response is to institute minimal regulation in order to prevent irrational exuberance from encompassing the country's financial markets. In contrast, this paper argues that the most effective method of eliminating irrational exuberance from the American economy is to eliminate the economy's excessive dependence upon financial market activity to generate economic growth. This would most effectively be achieved through a return to productive-based growth reminiscent of the American planning system of the Golden Age period. However this embodies a reorientation in economic thinking that the conventional policy approach has thus far proved unwilling to consider. As such, there is a vital need for an expansion in the current economic debate, along with a re-examination of the historical processes that have led up to the contemporary recession.

Chapter 2: A Re-examination of the 1970s

Introduction

One of the reasons why the current policy debate has only involved a light re-tinkering of the neo-liberal tradition rather than a radical overhaul is due to the perceived failure of Keynesian policies in the 1970s. As we saw in the last chapter, Keynesian-like policies of demand management proved extremely effective in placing the US economy on a high-road economic model based on the growth of employment and wages, along with the technological advancement of American society. Nevertheless, despite this empirical success, orthodox economists today claim that this system of economic growth created a number of inefficiencies that later led to the emergence of 'stagflation' in the 1970s. This widespread assertion has effectively discredited the Keynesian tradition from the current policy debate, demonstrated by the fact that while the rhetoric for a return to Keynesianism has been gestured at by contemporary policymakers, this rhetoric has not been matched by a translation into actual policymaking.

The avoidance of demand management in the policy-making arena is primarily due to the widespread perception that the application of Keynesian policies in the postwar period led to the economic problems of the 1970s. However this perception of postwar economic history is based on a version of events whose scope of analysis has largely been confined to the neoliberal paradigm. This chapter analyses the decade of the 1970s from an alternative perspective, in order to introduce the question of whether it was in fact the failure of Keynesian policies that produced the problems of the 1970s, or whether in fact there was more to the story that has been missed by the analytical focus of the neoliberal paradigm.

The previous chapter illustrated how the high-road economic model of the planning system was ultimately centred on the complicit consent by the established corporations of the period to refrain from engaging in aggressive price competition. This chapter will show how, along with the increasing integration of the international economy during the 1970s, a number of external factors emerged that challenged this domestically-centred normative regime. It is the influence of these international factors upon the American economy that will embody the focus of this chapter.

The first sections of the chapter will analyse the rise of the export-oriented model of economic development, as successfully practised by West Germany and Japan during this period. This growth model was centred on keeping domestic demand within these economies low, so as to keep their costs of production down in order to render their exports price-competitive inside the US consumer markets. The initiation of this strategy, it will be argued, undermined the stability of the domestically oriented American planning system.

The chapter will then go on to examine both the Keynesian and neo-classical arguments that were proposed to address the problem of industrial stagnation within the American economy during this period. It will be argued that in contrast to the neo-classical assertion that the emergence of stagnation empirically invalidates the Keynesian position; the failure of Keynesian policies to stimulate the American economy in the 1970s was primarily due to the influence of the unfettered nature of the wider international environment, which undermined the application of domestically oriented demand management policies.

A significant component of this unfettered international economy was the rise of the unregulated Eurodollar market during this decade. The chapter will show how the emergence of this unregulated international market enabled American banks to evade the lending limits imposed by the Federal Reserve at this time, leading to an expansion in consumer credit and the emergence of price inflation decoupled from economic growth within the US economy. It was the combination of price-aggressive foreign competition along with unregulated borrowing from the Eurodollar market, the paper argues, which led to the emergence of 'stagflation' within the American economy during the 1970s.

The root cause of the economic problems of the 1970s was the opening up of a significant imbalance within the international economy between the factors of supply and demand, as export-oriented nations exponentially increased the amount of supply within the global economy without correspondingly increasing the level of aggregate demand. The final section of the chapter will analyse the attempt undertaken by the Carter administration to address this international imbalance through an inter-governmental global growth stimulus strategy. It was the political discrediting of this strategy within the United States, the chapter argues, that led to the ascension of the neo-classical tradition and the subsequent financialisation of the American economy.

West Germany and Japan 'Catch-up'

The economic gains of the Golden Age soon filtered through into the economies of the advanced capitalist world, generating a period of prosperity amongst the industrially developed bloc. Initially these gains were spread through direct government interaction, as the US government donated public works grants to the Western European nations under the initiative of the Marshall Plan. Japan too received significant US aid grants during this time, especially with the onset of the Korean War in 1950. Indeed the scholar Chalmers Johnson, who served in Korea during this time, maintained that the war was "the equivalent for Japan of the Marshall Plan".[40] As such US aid grants provided an important source of funds that enabled these economies to rebuild their economic infrastructure and rapidly re-engage in the growth pattern of advanced industrial production that had been the norm in these nations prior to the outbreak of war in 1939.

As a result of their rapid reorientation back into advanced industrial production, together with the consistently impressive growth levels achieved during this Golden Age period, production soon expanded amongst the majority of advanced capitalist nations. Indeed this growth became significant enough to warrant export sales by these countries and world trade steadily grew during this period.

Central to this rapid economic growth was the existence of highly skilled labour forces within these advanced capitalist nations. Thus even though their economic infrastructure had been largely destroyed by the war, the knowledge and skills of each country's work-force enabled their infrastructure to be rapidly rebuilt (with the help of American capital), and technological progression to once again be initiated throughout their respective economies.

For example, in the case of Germany, the scholar Robert Brenner attributes the rapid growth of manufacturing during this period to the country's highly skilled labour force, itself "the product of long-established industrial traditions". In this manner, Germany's post-war economic "miracle" was dependent to a considerable extent on the

[40] Chalmers Johnson cited in Eric Helleiner, *States and the re-emergence of Global Finance: From Bretton Woods to the 1990s*, Cornell University Press, 1994, P.74

utilisation of its skilled labour force to recover its historical prominence in advanced industrial production. This prior prominence is clearly demonstrated by the fact that in the "1920s and 1930s, Germany held a share of world manufacturing exports equal to those of the UK and US, and was the world's leader in the overseas sale of chemicals and other manufactures". As a result, the "German economy was able to base its resurgence directly on its earlier achievements". This is clearly demonstrated by the fact that during "1952 and 1953, 80 per cent of exported branded articles [coming from Germany] were sold using international trade marks valid before the war".[41]

The economies of Western Europe and Japan also benefited from the process of 'catch-up', from which they were enabled to leapfrog the initial capital-intensive period of development that had already been undertaken by producers in the United States. Because US industry was largely responsible for a great number of the technological innovations that emerged in the early postwar period, they shouldered the great majority of the initial costs involved in the research and development of these innovations. Thus by leapfrogging the initial intensive investment period already undertaken by American industry, Japan and Germany were able to, over a relatively short space of time, advance to a level whereby they could effectively compete on price against American manufacturers. Heavily advantaged by the fact that they did not have to sink any capital into the initial development period of the product, Japanese and German firms were thus able to divert more resources towards generating productivity and efficiency gains on the finished product, thus enhancing their ability to compete on price.[42]

In consequence, by 1965, the economies of West Germany and Japan had advanced to a level whereby their exports were able to achieve significant inroads into the United States' consumer market. As a result, the level of competition within the US domestic market heightened considerably. This proved extremely destabilising to the 'planning system' that governed economic relations in the country during that time. Being based upon the dominance of three to four large firms within each industrial sector, and with each firm enjoying relatively entrenched market positions, the rapid introduction of foreign competition proved a serious blow to the complicit coordination strategies of the post-war corporate planning system.

This problem was further compounded by the fact that the German and Japanese producers based their competitiveness on a cheaper price for their product than that

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[41] Robert Brenner, *The Economics of Global Turbulence: The Advanced Capitalist Economies from Long Boom to Long Downturn, 1945-2005*, London, Verso 2006, P.69
[42] Ibid, pp 44-45

which prevailed in the US planning system. As we have seen, the complicit agreement to not engage in aggressive price competition was one of the principal (if not the pre-eminent) building blocks of the post-war corporate planning system. As such, the steady increase of cheaper imports post-1965 proved to be a dramatically destabilising factor, preventing the effective continuation of this normative regime. The sudden need to concentrate on the immediate future in order to hold on to current market-shares, distracted American firms from their long-term investment strategies. Moreover, an increasing allocation of resources was now required by American firms to maintain profitability in the face of reduced market-shares. This took an escalating amount of resources away from long-term investment in innovative production. The basis for the stagnating industries of the 1970's had begun.

The Export-Oriented Model of Development

Before we look at the deteriorating prospects of American industry, it is important to determine the means in which the German and Japanese companies were able to undercut American manufacturers on their own home soil. In this regard, the cost-competitiveness of their products was primarily achieved via an export-oriented strategy of economic development. Under this strategy, production is rapidly increased but domestic demand is not. As a result the costs of production are kept low, thus providing a means to profitably undercut American companies. The only corollary of this strategy is that domestic demand becomes increasingly unable to consume the increase in production, thus exacerbating the dependence on export markets for economic growth. Nevertheless, this export-oriented strategy initially proved extremely successful for the German and Japanese economies, accounting for a considerable degree of their economic growth during this period.

The strategy of keeping domestic demand low in order to increase cost-competitiveness and thus generate growth through export markets is clearly demonstrated by the considerable divergence between productivity statistics and wage growth within these economies during this period. Take West Germany for example. Here between "1948 and 1951, labour productivity increased by a spectacular 50 per cent, but product wages grew by just a quarter".[43] This therefore enabled German manufacturers to utilise the nation's highly-skilled labour force to undertake advanced

[43] Ibid, P.69

technological production at a fraction of the cost encountered by their American competitors.

In Japan too, a similar set of circumstances developed. "Between 1950 and 1960, Japanese manufacturing output grew at an average annual rate of 16.7 per cent, and GNP at about 10 per cent – the highest rates among the advanced capitalist economies".[44] However despite this growth, between "1952 and 1961, the real consumer wage increased at an average annual rate of 4.7 percent, [and] the real product wage at an average annual rate of 6.1 per cent". As such, wages only grew "two-thirds as fast as labour productivity". As a result the manufacturing profit share "rose at an average annual rate of 6.6 per cent during these years".[45] The great gap between profits and costs provided considerable capital for Japanese firms to invest in productivity-improving innovations, along with initiating technological advancements of pre-existing products. Nevertheless, the considerable divergence between corporate profits and the domestic capacity for consumer demand (as evident in the above wage statistics) highlights the ultimate dependence the Japanese placed on the US consumer market to achieve economic growth.

Foreign Competition and the Planning System

The intensification of international competition within the American consumer market clearly had an impact on the profitability of the dominant manufacturing corporations that encompassed the largest wealth-generating entities within the US economy. The extent of this impact was considerable, demonstrated by the fact that between "1965 and 1973, the rates of profit in the manufacturing and private business sectors fell by 40.0 per cent and 29.3 per cent respectively".[46] A principal problem for the future productivity of the US economy was that at the time the 'planning system' had not planned for such a rapid incursion into their immediate profits. In the absence of former price competition, American corporations had generally assumed that prices would gradually rise over time (along with wages).

The relatively rapid influx of foreign competition post-1965 therefore proved to be a major destabilising factor, preventing the realisation of the long-term technological investments that provided the backbone to the productive source of wealth-generation

[44] Ibid, P.82
[45] Ibid
[46] Ibid, P.92

during that period. In consequence, between "1965 and 1973, US manufacturers sustained a decline in the rate of return on their capital stock of over 40 per cent".[47] This failure to realise their previously projected rate of return on their investments meant that a significant proportion of the internal revenue of American corporations had essentially gone to waste. Moreover, this problem was further compounded by the reduced rates of profit American firms now found themselves able to generate, as foreign competitors made major inroads into their respective market-shares and forced significant reductions on the prices (and thus revenue) for their products within the American consumer market.

The combination of reduced rates of profits, along with the inability of productive investments to generate greater returns for future profitability, seriously undermined the internal capacity of American corporations to finance their own productive investment. As a result, American manufacturing firms assumed greater dependence on the financial sector as a source of funds to finance their long-term investment projects. This was a dependence that American firms had long aimed to prevent, in an effort to reduce the power of financial interests over their productive operations. As we shall later see, the renewed power of the financial sector to influence and direct the investment decisions of American corporations was to become a key catalyst in the transformation of the US economy away from productive wealth-generation towards financial speculation, as the driving engine behind America's economic prospects.

The renewed importance and influence of the financial sector is clearly evident from the transformation of banking operations during this period. Writing at this time, the scholar William G. Shepherd observed that before "1960, bank loans to companies were mainly short-term credit, to finance routine cash needs of firms (for example seasonal inventory shifts and payrolls)".[48] This nature of banking operations reflects the aforementioned corporate investment strategy of the planning system, where long-term productive investment was financed out of a firm's own internal revenue streams, thus limiting dependence on financial institutions. However from the mid 1960's onwards, Shepherd observed "a strong shift into long-term loans, for nonrecurring basic corporate projects".[49] This shift reflects the renewed dependence of American manufacturing

[47] Ibid, P.99
[48] William G. Sheperd, 'The Banking Industry' in Walter Adams, *The Structure of American Industry*, New York Macmillan, 1971, P.338
[49] Ibid

corporations on the financial sector for their long-term industrial investment projects. In light of the reduced revenue American corporations now received as a result of intensified international competition within their home market, this increased dependence was deemed a necessity if they wished to maintain their current growth path based on productive investment.

Increased interaction with financial institutions raised the costs associated with productive investment for American corporations. This is clearly evident in the increase of interest payments by US firms during this period. Between "1950 and 1965, interest payments had constituted a mere 1 per cent of profits" for American manufacturers. However this figure "jumped to 11 per cent between 1965 and 1973, as profitability fell sharply".[50] With increased costs associated with investment, along with dwindling returns from this investment, competition based on productivity improvements or the marketing of novel electronic products became harder to sustain. In consequence, price competition became the name of the game. The problem for American industry thus became one of a downward pressure on prices. This rendered it progressively more difficult for American firms to mark up prices over costs to a sufficient level from which they could generate enough internal revenue to re-embark on the long-term growth strategies that characterised the planning system of the Golden Age period.

Supply vs. Demand

Enter into this mix the 1973 OPEC oil price shocks. The rise in the price of oil as an intermediate product in the manufacture of many American products considerably compounded the difficulty of marking up prices to a sufficient level over costs. It is here where we begin to see the germ of the supply-side argument take hold. According to the supply-side argument, the problem with American industry was that it was essentially inefficient in its production. With their costs of production too high, American corporations represented bloated bureaucracies, whose inefficiencies rendered them ineffective against their 'leaner' foreign competitors. The solution was simple: reduce the cost of production and achieve greater efficiency.[51]

One of the largest and most readily adaptable cost components of production was labour. This supply-side rationale came to constitute the economic basis behind the

[50] Brenner, *Economics of Global Turbulence*, P.

[51] Michael Perelman, *The Confiscation of American Prosperity: From Right-Wing Extremism and Economic Ideology to the Next Great Depression*, New York, Palgrave Macmillan, 2007, P.103

attack on organised labour under the regime of the Reagan administration during the 1980s. According to this argument, American wages had far outstripped the ability of firms to effectively pay. This was because wages had been largely insulated from the market and thus prevented from reaching their 'equilibrium' level, owing to the protection offered by the political institution of trade unions. As such, the theory argued, if American firms were to effectively compete against foreign manufacturers, they would have to reduce their labour costs. If this reduction was to be effective, then the power and protection offered by the trade unions would have to be reduced as well. This was required in order to allow market forces to determine the 'equilibrium' level of wages in the country. In consequence, it was America's workers who became the primary target of adjustment measures undertaken in response to the rapid infiltration of foreign competition into the US economy post-1965.[52]

However this supply-side argument totally ignores (in fact it undermines) the key to successful growth during the Golden Age period, namely: a domestic consumer market that was able to grow alongside American industry, ensuring effective aggregate demand to match the growth of supply by American business. The combination of rising unemployment, stagnating wages and withdrawals from productive long-term investment during the 1970s, dramatically decreased the degree of aggregate demand prevalent throughout the US economy at this time.

The problem was therefore not one of supply, but rather the reverse, that of inadequate demand. Germany and Japan had entered the international economy through a rapid expansion of exports, but they had done this without simultaneously increasing the level of demand within their own economies. As a result the increase of international suppliers was not balanced by an increase in international buyers. The mid 1960's thus saw a dramatic increase in the number of companies selling on the world stage, but the consumer market for this elevated number of companies was not sufficiently enlarged to incorporate the influx of new companies operating at the global level. The depression of domestic demand within the German and Japanese economies thus meant that the United States' consumer market was overwhelmingly relied upon as the main source of demand for the global economy taken as a whole.

However the US response to the intensification of competition within its domestic economy was to undertake efficiency measures that further decreased the

[52] William Mitchel and Joan Muysken, 'Full Employment Abandoned: Shifting Sands and Policy Failures', in *International Journal of Public Policy*, Vol. 5, No.10, 2010, P.12

degree of aggregate demand being exercised throughout the global economy. The intensification of international competition that this move induced, heralded the end of the Golden Age era of growth. A new set of conditions gripped the global economy, as competition heightened and the ability to undertake successive price reductions became the pivotal scope of export competitiveness.[53] Contemporary scholars label this new system a 'race to the bottom', with constant cost-cutting and efficiency measures placing an ongoing depressant on global demand, intensifying international competition in the process.[54]

In changing its focus from demand-management to one of how to create competitive conditions of supply, economic doctrine experienced a significant ideological shift in this period. For the duration of the Golden Age, the prevailing economic doctrine was that of Keynesian demand-management. Keynesian ideas had prevailed ever since the policy prescriptions of John Maynard Keynes had provided an effective measure in stimulating national economies out of the extreme depression that had decimated industrial production during the interwar years. However the seemingly ineffectiveness of these policies in enabling the United States to overcome its twin problems of stagnation and inflation - or 'stagflation' as it was later termed – led to the discrediting of this set of ideas. In turn this led to a greater reception to the monetarist ideas of Milton Friedman and other neo-classical economists writing during this period. In order to analyse the reasons why Keynesian demand-management proved ineffective in rectifying stagflation, it is necessary to look at this theory in detail. It is to this topic that the paper now addresses.

The Keynesian Theory of Demand-Management

Keynes's theory of demand-management highlighted the potential for the public sector to stimulate growth out of an economic downturn. Keynes' showed how at the onset of a business slowdown, the prevailing market conditions induced cautionary measures amongst both industrial firms and households alike. Responding to a market downturn, firms will reduce their investment and growth, narrowing employment prospects in the process. Households respond to these narrower prospects by reducing their consumption and increasing their savings, thus effectively removing liquidity from

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[53] Brenner, *Economics of Global Turbulence*, pp 38-39

[54] Ajit Singh, 'Labour Standards and the 'race to the bottom': Rethinking Globalization and Worker's Rights from Developmental and Solidaristic Perspectives' in *Oxford Review of Economic Policy*, Vol.20, No.1, 2004, P.85

the national economy. This reduced consumer spending eats into company profits, impacting their profitability and potentially leading to increased redundancies as companies reduce their costs as a means to maintain their business. In this way a business downturn induces a recessionary cycle, with severe repercussions to the national economy if left unchecked.[55]

In solution, Keynes proposed two government-directed measures to address this market problem. The first method was to be employed in periods of general economic slowdown, notably towards the end of the business cycle when most economies enter into a short stage of recession. Keynes argued that left solely to market forces, the loss of business confidence, output and investment during the initial recessionary stages can reduce levels of aggregate demand to such a state that firms' profitability is reduced to the point of bankruptcy and a severe depression will grip the nation. Keynes proposed a pre-emptive measure against this downward spiral. He argued that in the initial stages of a downturn, the overnight rates set by the central bank should be lowered, in order to make it easier and cheaper for firms to borrow, thus providing the financial liquidity to maintain investment and production at the levels that prevailed before the downturn. This reduces the need to make cut backs on employment or other costs of production. As a result the impact of the recession is minimised and its duration significantly shortened.[56]

The second method is one that is to be implemented only when a recession has deteriorated to the point of depression. Here a stronger stimulus measure is required. This is necessary because in such a depressed state of demand, it does not matter how low interest rates go, firms will avoid undertaking any new investment or growth because household spending is so low that an expansion in production will not lead to a sufficient increase in sales to warrant the initial expense of expansion. Here, the proposed solution is for the government itself to become directly involved in the economy, by creating jobs within the public sector for those individuals rendered unemployed due to depression. The increased financial stability that this new employment provides encourages households to increase their spending levels, as their confidence in their economic prospects is elevated by their recent employment. This increase in household spending increases the sales of the nation's firms, increasing their

[55] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, London Macmillan, 1936, pp 257-275

[56] Paul Krugman, *Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations*, 1994, P.31

revenue and providing a market incentive to increase production and employment, along with undertaking new investment initiatives. Thus through an initial government injection, business confidence is increased and the economy is enabled to grow its way out of the depression.[57]

Of these two methods, the first of the two - a reduction in the overnight rates of interest set by the central bank – was by far the most preferred method for American policymakers throughout the postwar period. The second proposal - that of the government creating jobs within the public sector – was considered only as an option of last resort, to be employed in situations of dire need, such as the severe depression that gripped the nation during the 1930s.[58]

However, this last resort approach ignores the degree in which direct government spending aided the stability and growth prevalent throughout the Golden Age period. Admittedly, the United States government did not as much directly create jobs as it did provide a customer for the production of advanced military technologies by American manufacturers. Nevertheless, in the absence of this government spending, the incentive to research and develop such technologies would be markedly reduced, as the corresponding risk of undertaking such investment would be exponentially increased due to the absence of a stable customer. In turn, the spin-off effects civilian technologies gained from the advances made in the government-funded military field would have been markedly reduced.

Thus the Keynesian tool that American policymakers preferred to officially employ in the 1970's with the onset of stagflation was a Federal Reserve initiated reduction in interest rates. Indeed this policy tool became increasingly attractive from the mid 1960s' on, as increased liquidity began to circulate around the global economy following a number of international developments. These developments include: the establishment of the Euromarket; the initiation of full convertibility of Western European currencies in 1958; the related relaxation of controls on their current accounts; and finally, the rise of multinational corporate activity. All of these developments will be discussed in detail below. For now it suffices to say that the increased liquidity associated with these developments introduced a source of funds that the US government could draw on to finance its Keynesian strategy of lowering the cost of credit within its domestic economy.

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[57] Ibid, P.32
[58] Ibid

Keynesianism in the Era of Globalisation

Due to its prevailing reserve-currency status, along with the fact that trade in a large number of important commodities – most notably oil – was conducted in dollars, a large demand for US dollars existed among the central banks of other national governments. This demand was further increased by the cost-competitive export-oriented growth strategies of Japan, Germany and other less-advanced capitalist nations. In order to ensure that their exports would be cost-competitive within the US market, it was necessary for their currencies to be of a lesser value than that of the dollar. With lower valued currencies, the export of their goods would be comparatively cheaper than the goods produced in the United States, whose higher valued dollar rendered its products considerably more expensive.

In order to maintain a lower value for their currencies vis-à-vis that of the US dollar, the central banks of these countries actively purchased dollar-denominated assets from the US government, and stored these dollar reserves within their own central bank holdings. In this way the international demand for the US dollar was increased while that of their currencies was reduced, ensuring a higher valuation for the US dollar compared to that of their own. With a cheaper currency, their exporters were tremendously assisted in their cost-competitive strategy of acquiring market inroads into the US consumer market. In this manner, monetary arrangements could be manipulated by national governments in order to assist the profitability and export success of their real productive economy.[59]

The benefit to the United States of this system was that it had become relatively inexpensive to engage in the interest-rate reduction Keynesian policy prescription. Financing its way out of recessionary conditions became as simple as the Federal Reserve printing more money. With more US dollars circulating throughout the system, other national governments were forced to purchase additional dollar-denominated assets in order to maintain the lower value of their currency compared to that of the dollar. In this way, the United States could afford to undertake progressively larger federal budget deficits and allow these deficits to be financed by foreign governments.[60]

The problem with this approach of increasing financial liquidity through foreign borrowings is that it introduced inflationary conditions into the country without

[59] Eric Helleiner, *States and the re-emergence of Global Finance: From Bretton Woods to the 1990s*, Cornell University Press, 1994, P.92
[60] Ibid pp 113-114

allowing for a corresponding rise in economic growth to absorb this inflation. The primary problem for the US economy in the 1970s was the intensification of international competition within its domestic market. In consequence, the government-directed stimulus measures failed to induce American corporations to undertake new investment initiatives, as the market competition was so fierce that the prospects for an adequate return on a new investment was markedly reduced. Thus with more liquidity (in the form of credit) circulating the national economy, but intensified competition curtailing long-term investment prospects, prices throughout the US economy began to rise in line with the increase in the largely credit-created conditions of consumer demand. According to the scholar Robert Brenner, "[f]aced as they were with declining rates of profit, and thus reduced surpluses and a deteriorating business climate, US manufacturers naturally responded to any given increase in demand with relatively lower levels of growth of output and investment than previously, as, for example in the period of rising profitability between 1961 to 1965". As a result, Brenner observed, "the increased demand that resulted from rising government deficits was thus predictably unable to stimulate a corresponding increase in domestic supply, and called forth instead more rapidly rising prices and imports".[61]

In this way it was primarily the economies of Japan and West Germany that benefited from the Keynesian stimulus measures initiated since the mid 1960's. With widespread inflation throughout the American economy, German and Japanese exporters could afford to raise their prices in line with American producers and still remain cost-competitive, aided by their lower valued currencies and cheaper production costs than those that prevailed within the United States. It is thus arguably clear that the stimulus measures enacted by the US government did in fact work in generating greater profitability, it was just that in the new globalized nature of economic relations, it was not the US economy that received these benefits but that of its primary competitors, thus compounding the primary problem of intensified competition for US producers at that time.

Due to the decreased returns of investment within the United States, compared to that of other advanced industrial economies, US corporations began to increase their investment overseas, largely at the expense of new production opportunities at home. As such there was a significant rise in multinational corporate activity beginning in this period. Brenner shows that by "1965, the ratio of investment by majority-owned foreign

[61] Brenner, *Economics of Global Turbulence*, P.124

affiliates of US corporations in manufacturing overseas to corporate manufacturing investment in the US had grown to 21.4 per cent, up from 11.4 per cent in 1957. By 1973, this had increased to 31.3 per cent". Another way of looking at this is that by 1973 US corporations were investing roughly one dollar overseas for every three dollars invested at home. As such, Brenner argues that there "could hardly be a clearer sign of the relative cost problem confronting manufacturing investors in the US economy at this point".[62]

The increase in multinational corporate activity during this period heightened the dependence of US firms on the financial sector, as manufacturing firms required the services of financial institutions in organising currency exchanges and other associated measures. With a greater need now for financial services, this sector began to grow in both size and importance within the increasingly internationalised economy. The political-economist Lawrence Krause observed at the time how "spurred by multinational firms, an active international bond market has developed outside the United States". The extent of this development is demonstrated by the fact that "in 1963, only half a billion dollars was raised through new international bond flotations outside the US, and 90 percent was for governments or International organisations". In contrast, by "1971, new flotations exceeded five billion dollars, with over half by private companies".[63]

Importantly, these currency transactions provided an avenue for increased profits via speculative tactics, divorced from the actual production undertaken by the company concerned. Krause observed that as American-based multinational "firms operate in many countries, they have knowledge of and financial ties to all major money markets and most smaller ones as well".[64] According to Krause:

> Corporate treasurers will shift their liquid funds from country to country in response to interest rate incentives and also will take positions in currencies in expectations of adjustments in exchange rates. Thus if the interest rate in one money market, for example Frankfurt, is higher than another one, for example New York, then firms will shift funds from the United States to Germany. Likewise, if one currency is thought to be a candidate for devaluation and

[62] Ibid PP 112-113
[63] Lawrence B. Krause, 'The International Economic System and the Multinational Corporation' in *The Annals of the American Academy of Political and Social Science*, Vol.403, No.1, September 1972, pp 99-100
[64] Ibid, P.100

another for revaluation, firms will move funds from the weaker into the stronger currency.[65]

From this we can see how speculative flows began to play an important role in exacerbating trends in the international currency markets. This was an important development, embodying a key catalyst in the subsequent financialisation of the international economy. It was one that was to have profound ramifications for the systemic structure of the US economy, as it increased its interaction with the international markets.

An outcome of increased overseas investment by US firms was that the US economy began to experience a considerable outflow of capital from the mid-1960s. In response to this development, US officials began to enact measures designed to tighten the regulations controlling capital flows out of the States. The first regulatory measure to discourage capital flows out of the country was the 1963 interest equalization tax (IET) on all new issues of foreign securities and equities sold in the US. In 1964, this tax was extended to cover "bank loans with a duration of one year or more as well as nonbank credits of one to three years".[66] The following year, 1965, saw the establishment of a voluntary capital controls program, which was notable in that it not only imposed controls upon US banks, but also upon the activities of non-financial multinational corporations, headquartered in the United States.[67]

Nevertheless the financial infrastructure that had developed in the international sphere enabled US based multinationals to circumvent these domestic controls. This was primarily achieved through the private Eurodollar market that developed in London during this period. It is to this development that we shall now turn.

Unregulated Global Finance: The Eurodollar Market

The Eurodollar market began as an attempt by the British government and the banks of London to regain the financial prominence they had formerly held in the international economy during the colonial period of the 18th and 19th Centuries. During the concluding agreements of the Second World War, Britain, bowing to US pressure, ceded to the dismantling of its formal colonial trading system. US diplomats wished to

[65] Ibid
[66] Helleiner, *States and the Re-emergence of Global Finance*, P. 85
[67] Ibid, P.86

create a more open market for international trade in goods and services, a market in which the then superior manufacturing capabilities of US corporations would be able to dominate, as opposed to one where trade was favoured along the lines of old colonial ties.[68]

Despite the dismantling of this formal system however, established links ensured that trade largely followed along the lines of the previous colonial regime. As a result, up until the year "1957, the financing of this [informal] trading system - accounting for about forty percent of all international trade – took the form of loans of the British pound sterling".[69] However the nationalisation of the Suez Canal that year threatened to become a major destabilising factor for the continuation of this informal trading regime. According to the scholar Edwin Dickens, without "the inflow of capital from the Suez Canal, the British banking system could no longer supply an outflow of capital to finance the trade of the former colonies".[70] However, owing to the substantial flow of US dollars circulating around the global economy, London banks found they could continue on with their foreign financing through the use of dollars rather than sterling. Demand for the dollar proved high, due to the dollar's special status in the international economy. As such, London banks were not only able to maintain the financing of their trading regime, but also expand their lending and foreign financial business considerably, through the use of dollars as a source of loans.[71]

This development proved highly destabilising to the established nature of banking operations within the domestic economy of the United States. During the early years of the postwar period, American banks conducted their business according to the norms that prevailed throughout most established industries within the US economy at that time. That is, they ran their business according to the accepted convention of maintaining industry stability by refraining from enacting undercutting activities against their market competitors. The following account given by William Shepherd provides an apt description of the US banking industry as it then existed.

> Banking has long had a fraternal, "professional" code of ethics against price cutting and many other competitive causes of instability. Interest is not to be

[68] Edwin Dickens, 'The Eurodollar Market and the New Era of Global Financialization' in Gerald A. Epstein, *Financialization and the World Economy*, Edward Elgar Publishing, 2005, P.211
[69] Ibid
[70] Ibid
[71] Ibid, pp211-212

> given on deposits; gentlemen's agreements keep banks from encroaching on each other's areas; and large accounts are not crassly competed for.[72]

This system of banking worked fine in the nationally confined period of the Golden Age. However, like other American industries, this stability was seriously undermined in the mid-1960s with the introduction of external actors operating outside the corporate culture of the United States. In this instance, the outside actor was the Eurodollar market in London. Owing to an industry-wide agreement on the price of loans offered by US banks (a reflection of the complicit price coordination strategy that prevailed throughout American corporate culture during this period), London bankers found they were able to attract international clients by pricing their dollar-based loans below the price that prevailed inside the United States. The industry-wide "price for dollar loans in the early 1960's was a 4.5 percent leading rate plus a requirement that borrowers maintain compensating balances of 10 percent to 20 percent of loans". As such, the cost of borrowing from US banks "ranged from 0.045/1 – 0.045/1 – 0.2, or from 5 and 5.6 percent". During this time, "the interest rate on Eurodollar deposits averaged 4.1 percent". As a result, the British banks could bid for dollar deposits from nations who held a surplus reserve of dollars looking for a profitable place to store them, and then lend this money at profitable margins while still underpricing the rate offered by US banks. In consequence, by "the end of 1965 the British banks had attracted $5.3 billion of Eurodollar deposits, an amount equal to that of the $33.8 billion dollars [US] sloshing around the world economy" at that time.[73]

The success of the Euromarket, combined with the tighter regulations banks now faced inside the United States, encouraged a number of American banks to turn to the Euromarket as a means to conduct unregulated business. Dickens observes that "from 1966 on, the growing use of Eurodollars by British banks to finance their foreign operations was complemented by the growing use of Eurodollars by the US bank cartel to finance its operations".[74]

The key catalyst for this growing use of Eurodollar financing by US banks was the restrictions placed on bank lending by the Federal Reserve in response to the August 1966 raise in lending rates, which all US banks agreed to initiate. This raise was opposed by the Fed "on the grounds that the higher rates were tantamount to higher costs of working capital which corporations could use to justify higher prices". Thus in

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[72] Shepherd, 'Banking Industry' in Adams *Structure of American Industry*, P.351
[73] Dickens, 'The Eurodollar Market' in Epstein, *Financialization and the World Economy*, P.212
[74] Ibid, P.213

an effort to curtail an inflationary spiral as companies passed on their higher costs of financing on to consumers, the Federal Reserve restricted the funds available for US banks to invest. Rather than accept this restriction however, US banks turned to the Euromarket as a source of funds for their lending activity. This move marked “the first time the Eurodollar market came to widespread public attention”.[75]

The turn to the Euromarket by US banks represented an important turning point in the growth of the private international financial system, a system that was essentially divorced from the governance and regulatory control of any national government. The use of Eurodollar funds by US banks expanded and transformed the nature of that market “from a short-term money market into a full-fledged international capital market”.[76] The scholar Eric Helleiner argues that the main attraction of the Euromarket was that it could be utilised in order to escape domestic regulation. He maintains that “for the U.S. financial community, the London Euromarket provided a setting where they could conduct their international activities unencumbered by an increasingly unfriendly federal government”.[77]

The principal source of Eurodollars that the US banks drew from was that of the Bundesbank, the German central bank. This relationship fitted in well with the system of trading relations that predominated during that period between the two countries. As part of its export-oriented economic growth strategy, Germany ran persistent trade surpluses with the United States, selling far more to the US than it consumed in US exports. As we have seen, this strategy was largely based on a cheaper valuation of the deutschemark compared to that of the dollar. Due to its efforts to maintain a cheaper currency, along with its accumulation of dollars via its constant trade surplus, the Bundesbank held a considerable store of dollar reserves within its holdings. The Euromarket thus provided a profitable outlet for the Bundesbank to recycle these dollar holdings.[78]

Thus through the financial intermediary of the Euromarket, the German central bank could lend its dollar surplus to the US banks, who then repatriated the money back into the United States. This lending process pumped up the international demand for the dollar, thus maintaining the lower valuation of the German mark and the cost-competitiveness of German exports. It also supplied the US with the financial liquidity

[75] Ibid, P.214
[76] Helleiner, *States and the re-emergence of Global Finance, P.89*
[77] Ibid
[78] Dickens, ‘The Eurodollar Market’ in Epstein, *Financialization and the World Economy*, P.215

required to purchase the German goods being sold within the US consumer markets.[79] In consequence, the increase in financial liquidity and the undermining of US corporate competitiveness that this process ultimately entailed, contributed significantly to the simultaneous appearance of an inflationary economy and stagnating industry inside the United States. Thus in contrast to the neoliberal assertion that liberalising finance would help solve the stagflationary tendencies of the US economy, it was the undermining of regulatory control through the private offshore Euromarket that largely contributed to the emergence of stagflation in the first place.

As a result, the Euromarket became a way for the US economy to generate cheap credit in order to tide over production in the face of a business slow down. This came to constitute a key characteristic of the US economy over the next thirty years, as the Keynesian solution of lowering interest rates was adopted as a means to stimulate the economy out of the series of recessions that began in the mid 1970s. Indeed, the reliance on foreign finance to generate the liquidity that its productive economy could no longer supply is one of the major causative factors behind the 2008 recession. Its origins can therefore be traced back to the expansion of the Euromarket in the mid 1960s, and its ability to circumvent the national regulations governing credit creation within the domestic economy of the United States.

Nevertheless, this system, whereby Germany and other countries financed the United States deficit, providing it with the financial liquidity to spend beyond its means and thus fuel the export-oriented boom of Japan and Germany, ultimately proved unsustainable and thus self-undermining. This first became evident during the build-up to the breakdown of the Bretton Woods system in the early 1970s.

The Breakdown of Bretton Woods and the Rise of Private Finance

The United States monetary authorities began to encounter serious difficulties in managing the reserve currency status of the US dollar from the beginning of the 1960s. Already at this stage, there was a large amount of dollars circulating outside the US economy, an inevitable outcome of the dollar's reserve status and the fact that a large portion of international trade was now conducted in dollars. Indeed by "1961, the ratio of dollars to gold outside the United States had risen above levels that would be

[79] Ibid

willingly held at $35 per ounce of gold".[80] In response, the market price for gold shot up, while that for dollars dwindled. As such, the incentive for central banks to trade in their dollar deposits for gold from the United States Treasury increased in line with this change in market valuation. The expansion of world trade and the rise of the private Euromarket exacerbated these conditions considerably.

In fact the development of the private Euromarket proved to be a major factor behind the breakdown of the Bretton Woods system. One of the factors which initially ignited inflation inside the United States was the ability of its banks to increase their lending rates in the face of Federal Reserve restrictions. This was achieved through borrowings made from the unregulated Euromarket as a substitute for funds from the publicly managed Reserve Bank. In response, American corporations, reacting to the increase in their costs of financing from the country's financial sector, passed these costs onto their consumers via the enactment of higher prices. Observing this trend, the German monetary authorities began to worry that inflation would be recycled back into the German economy, as German manufacturers were able to raise their prices in line with American producers. The German government thus began to apply pressure on the US government to impose reserve requirements on all US bank borrowings in the Euromarket, employing its considerable holdings of US Treasury bills as diplomatic leverage in order to attain this objective. Reserve requirements were thus implemented in the United States, and the borrowing by American banks on the Euromarket decreased from a "1969 peak of $12,118 million to $3,300 million in 1971".[81]

However these reserve requirements failed to halt both the expansion of the Euromarket or the spread of inflation from the US market into the German economy. In response to the reserve requirements, an increased amount of dollar holdings flooded into the Euromarket. This thus reduced the pre-eminent role of the Bundesbank as provider of official dollar reserves and the market became much more diversified and increasingly more volatile as a result. This diversification precipitated a move away from long-term lending to one of more short-term and speculative capital flows. Edwin Dickens argues that this development "institutionalized a vast pool of short-term capital, outside the control of any monetary authority, which was ready and able to move with lightning speed in and out of different currencies".[82]

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[80] Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System*, Princeton University Press, 2008, P.121
[81] Dickens, 'The Eurodollar Market' in Epstein, *Financialization and the World Economy*, P.216
[82] Ibid

As the reserve currency holder, the United States found itself in a progressively more precarious position from the outset of the 1970s. With the short term speculative flows emanating from the Euromarket exacerbating the run on the dollar instigated by the demands of other national governments to exchange their dollar holdings for gold deposits, the ability of the US to maintain its role as central banker for the world economy became considerably more difficult to sustain. The ultimate solution out of this conundrum was for the United States to generate a sufficient surplus in its current account. This would provide it with the reserves to support its currency and thus increase international confidence in the dollar, ending the speculative run then in place upon it. Indeed, the British economy had experienced a similar dilemma in the 1840s and had employed an expansion of exports as a means to grow its economy out of this precarious position and thus maintain its hegemonic role within the world economy.[83] However with its primary competitors unwilling to expand demand within their own economies, such a strategy proved extremely difficult for the United States to initiate.

Foreseeing no other possible solution out of this conundrum, the United States' monetary authorities decided to abrogate itself from its international commitment to convert dollars for gold at thirty-five dollars per ounce, and embarked upon a mercantilist strategy of increasing its own competitiveness within the global economy. This was initiated under the Nixon Administration's 'New Economic Policy', which along with the suspension of dollar-gold convertibility, placed a ten percent surcharge on all imports and implemented a range of tax cuts for American producers and consumers alike.[84]

In response to the United States unilateral abrogation of its reserve role in the international monetary system, the national governments who made up the advanced capitalist world at the time, came together to work out an arrangement to save the state-managed fixed exchange rate regime that constituted the Brettons Woods system. The end result of these multilateral discussions was the signing of the Smithsonian Agreement in December 1971. Here it was agreed that the dollar should be devalued by a rate of 7.89 percent against gold, and the currencies of the other attending economies should be revalued against the dollar. This brought a revaluation of the mark by 13.5 percent and a revaluation of the yen by a total of 16.88 percent.[85]

[83] Eichengreen, *Globalizing Capital,* P.127
[84] Ibid, P.131
[85] Brenner *Economics of Global Turbulence*, P.128

Nevertheless, the Smithsonian parities held a particularly short shelf-life in this new international economic environment, as private short term flows continued to expand in an increasingly volatile manner. Indeed these flows proved particularly disruptive following the implementation of stimulus measures by the Nixon administration during the run-up to the 1972 presidential elections. The net effect of these measures was to significantly enlarge the federal budget deficit, while simultaneously increasing the level of liquid credit circulating throughout the US economy. This worked to increase inflation throughout the US economy, a process that increased both the competitiveness and profitability of German and Japanese exporters selling in the US market, who did not have to contend with the same rise in costs as US producers, and so were thus able to reap the benefits of economy-wide price rises by raising the price of their product but still being able to undercut US producers in the process. This culminated in "a tripling of the record trade deficit in 1972", a process that perpetuated a massive capital outflow away from the dollar towards the more competitive economies of West Germany and Japan. As a result, world reserves doubled the amount that existed in 1969, "increasing as much in the intervening three years as in all previous centuries of recorded history".[86]

This massive capital outflow ensured that as inflation increased inside the United States, this increase would also be carried over into the economies of its primary competitors. In an effort to contain inflation, the Nixon administration imposed a ninety day wage-price freeze. While this was able to temporarily contain inflation for the duration of the freeze, the build up of forces it precipitated unleashed a fresh new flow of inflationary conditions (and expectations) following the lifting of the freeze. As a result, "the annual rate of increase of consumer prices exploded from 3.9 per cent in the last quarter of 1972 to 6.2 per cent in the first quarter of 1973".[87]

The resulting outflow of inflationary capital from the US economy, led to an intergovernmental agreement to allow a further dollar devaluation to the magnitude of ten percent. Nevertheless despite this devaluation the "US authorities made clear that they were in no way committed to support the new parities or, by implication, even to the maintenance of a fixed-rate regime", thus undermining the prevailing system.[88] In response 27.8 billion deutschemarks flooded back into the German economy from the Euromarkets. Likewise the other economies of Western Europe, and even Japan, who

[86] Ibid
[87] Ibid
[88] Ibid

held particularly stringent capital controls, faced a massive influx of short-term capital rushing into their respective economies.[89]

These flows proved too much to contain, forcing these economies to dispense with their capital controls program and assume a floating rate regime for their currencies on the international markets. In line with the prevailing short-term trends, significant currency appreciation followed this floating. In the case of Germany, “the mark was revalued by 20.4 per cent against the dollar, making for an extraordinary total appreciation of the German currency against the dollar between 1969 and 1973 of 50 per cent”.[90] Japan’s currency “was revalued a further 12 per cent in 1973, making for a total appreciation since December 1971 of 28.2 per cent”.[91]

All of these changes in relative values between national currencies proved extremely beneficial to the competitiveness of US manufacturers, both at home and on the world stage. Indeed Brenner argues that in consequence of this, in “the space of a few short years, the US manufacturing sector secured by dollar devaluation the kind of turnaround in relative costs that it had been unable to achieve by way of productivity growth and wage restraint”.[92] The corollary of this increase in US competitiveness however was a reduction in the competitive prospects of the German and Japanese economies. This was a factor that had significant consequences for these countries, owing to the dependence they had placed on the US market for generating growth within their own economies. As Brenner shows, between “1970 and 1973, unit labour costs in manufacturing (expressed in dollars) grew at an average annual rate of 0.6 per cent in the US, compared to 17.6 per cent in Germany and 19 per cent in Japan. Over the same period, US relative unit labour costs in manufacturing fell on average by 9.9 per cent per year”. As a result the “average annual growth of US export prices between 1971 and 1973, at 9.5 percent, could therefore achieve rough equality with those of Japan, at 9 per cent, and Germany, at 8.7 per cent – after having grown at double Germany’s and at close to 5 times the rate of Japan’s between 1965 and 1970”.[93]

As can be seen, Japanese and German exporters lost a considerable degree of competitiveness via their currency revaluations during this period. Their response to this revaluation was to lower the prices for their products on the export markets, in order to

[89] Ibid
[90] Ibid
[91] Ibid, P.129
[92] Ibid
[93] Ibid

compensate for the increase in their currency valuation. For instance, Brenner shows how in Japan in the year “1972, unit labour costs in manufacturing in terms of the national currency rose by just 1.1 per cent, but in terms of a trade-weighted currency by no less than 11.8 per cent, and in terms of the dollar by a stunning 20.3 percent”. In order to preserve export competitiveness therefore, “Japanese manufacturers limited their export price increases in dollar terms to only 8 per cent”. This required a “reduction in their export prices in yen terms of 3 per cent, compared to an average annual increase of almost 2 per cent over the previous five years”.[94] Likewise in Germany, between “1969 and 1973… relative unit labour costs grew at the very large average annual rate of 6.1 per cent”, a development that Brenner argues is “entirely attributable to the increased value (effective exchange rate) of the mark”. In response “German exporters held down the increase of their export prices in terms of marks to an average annual rate of only 3.7 per cent”.[95]

This reduction in the market price for their exports left less revenue for internal investment or increased employment within their industrial companies. The net effect of this strategy was therefore to dampen demand within their domestic economies, exacerbating their dependence on the US consumer market to achieve growth. As such, this fresh new round of price reductions acted as a depressant on global aggregate demand and reduced revenue intakes considerably. This is clearly demonstrated by the fact that “between 1965 and 1973, aggregate manufacturing profitability in the G-7 economies declined by about 25.5 per cent”.[96] This constitutes a significant drop in profits and can thus be seen as a major catalyst for the international recession of 1974.

A Renewed Dependence on the Financial Sector

The US government responded to the global recession of 1974 by lowering the Federal Reserve discount rate in order to reduce the cost of borrowing and thus provide a financial incentive to encourage further investment. As such, the main concern for the US monetary authorities at this time was the need to attract sufficient levels of foreign capital to finance this credit-induced recovery of the domestic economy. However this was a task that was proving progressively difficult to achieve, especially with the

[94] Ibid, P.138
[95] Ibid, P.132
[96] Ibid, P.141

existence of the Euromarket and its ability to attract large sums of capital due its unregulated environment.

There thus began to build considerable pressure inside the United States for the government to liberalise the country's financial sector, in order to attract a greater share of the private financial funds circulating throughout the global economy. Indeed this was considered an imperative as the government's stimulus strategy required easier access for the nation's firms to financial capital, in order to compensate for the deteriorating investment prospects and the decline in profitability of the productive sector. The emergence of petrodollars as the OPEC countries sought to capitalise on their now considerable income streams following the 1973 oil price hike provided a further impetus to liberalise.[97]

The United States government thus began to institute significant deregulatory measures for its financial sector. This included: the "May Day" liberalisation of 1975 that abolished minimum commissions for securities trading; the abolishment of the previously mentioned capital controls program; and a number of other measures that facilitated the movement of free capital into the country.[98]

The deregulation of the financial sector, combined with the stimulus measures of lower-cost credit, significantly expanded the level of borrowing throughout the American economy. The prevalence of inflation also encouraged this trend by reducing both the cost and risk associated with borrowing. Over time, inflationary conditions depreciate the purchasing power of money, as prices rise throughout the economy. In turn, this also depreciates the real cost of the interest rate set at the outset of the original loan. To demonstrate, between "1973 and 1979, real interest rates fell below zero, averaging negative 0.1 per cent, compared to 2.5 percent between 1960 and 1973".[99] This was because the rate of inflation was larger than the interest rate or cost of credit. As such, when inflation was factored into the equation, the real cost of the loan was virtually nothing.

In consequence, American firms found a cost incentive to increase their borrowings in order to make up for their reduced competitiveness in their home market. By doing this however, they gradually moved away from their preferred position in the

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[97] Helleiner, *States and the re-emergence of Global Finance, P.114*

[98] Philip G. Cerny, 'The Infrastructure of the Infrastructure: Toward "Embedded Financial Orthodoxy" in the International Political Economy' in Ronen P. Palan, *Transcending the State-Global Divide:a Neo-Structuralist Agenda in International Relations* Boulder Colorado, Lynne Rienner Publishers, 1994, P.240

[99] Brenner, *Economics of Global Turbulence*, P.167

Golden Age years of limiting their dependence on external sources of finance to as much as possible. However the stagnation of the 1970s severely limited the ability of American firms to follow this Golden Age internal investment strategy, while the inflation of that decade reduced the risk associated with external financing.

It must be noted that this increased reliance on the financial sector significantly increased the profitability of the country's productive sector, providing a well-timed boost to productive investment that enabled the country to capitalise on its newly devalued currency and increase its industrial competitiveness within the international markets. This productive investment was able to be enacted due to the reduction in rentier repatriation that corporate managers imposed upon their shareholders, who correspondingly sacrificed short-term profits under the acknowledgement that their investment would gain greater long-term growth by financing real productivity improvements within the firm. In doing so shareholders subscribed to the prevailing investment strategy that had reigned supreme during the Golden Age years of economic growth.[100]

Thus between 1973 and 1979, "manufacturing corporate managers reduced annual dividend payments as a proportion of profits to just 16 per cent, compared to 26 per cent for 1950 and 1973". This reduction in annual dividend obligations enabled the "manufacturing sector to increase its investment in these years at an average annual rate of 5.6 per cent, about the same rate as between 1950 and 1973, when it was 5.8 per cent". Furthermore, during this same timeframe, the net capital stock of American corporations increased at "an average annual rate of 3.8 per cent, which was just about the same as between 1950 and 1973, when the figure had been 3.9 per cent".[101]

In turn this investment generated a rapid revival of profitability for American manufacturing corporations. "Between 1975 and 1979, manufacturing output rose at the average annual rate of 7.2 per cent, about the same rate as during the high boom years of 1958 and 1965". In the same period, "manufacturing labour productivity grew at the average annual rate of 2.6 per cent, not all that far below the average annual rate of 3.0 per cent between 1950 and 1973".[102]

This expansion in productivity, assisted by its now cheaper currency, enabled the United States to increase its export-sales within the world markets. Indeed this was a

[100] Ibid
[101] Ibid
[102] Ibid, P.168

significant achievement, especially considering the drop in global aggregate demand that occurred in this period. Indeed between "1973 and 1979, US exports increased at the average annual pace of 5.8 per cent". While this figure was only slightly higher than the 5.3 percent growth achieved during 1965 to 1971, it nevertheless signified a notable increase in international competitiveness, especially considering that "world trade grew in this period at only half the rate of the later 1960s and early1970s".[103]

Thus economic growth was able to be achieved in the second half of the 1970s via a much enlarged dependence on exports as an engine of growth within the US economy. The extent of this dependence is demonstrated by the fact that exports increased "as a proportion of GDP by 35 per cent" and "manufacturing exports as a proportion of manufacturing output by almost 50 per cent". In turn, the increased prospects for productive investment within the United States reversed the outflow of corporate capital from the country, demonstrated by the fact that while foreign direct investment had increased to thirty percent by 1973, it had come back down to twenty-one percent between 1975 to 1979.[104]

The Locomotive Strategy

Recognising the fact that the United States recovery was largely dependent on its recently devalued currency, along with increased access to foreign sources of credit, the Carter administration saw that the only way to translate this short-term recovery into a sustainable growth path was to increase the level of aggregate demand operating throughout the world economy as a whole. The Carter administration aimed to increase global demand by pursuing a multilateral-based stimulus package, whereby the three most powerful national economies at that time: the United States, Germany and Japan, would simultaneously embark upon a set of expansionary policies in order to act as an engine of growth for the world economy at large. In this way the three economies would function as "locomotives", providing a source of demand to pull the rest of the world out of the stagnation that mired the 1970s. The combined effort of these three economies would thus function in much the same way that the United States had in the decade of the 1960s, in providing the demand that grew the economies of Japan and Germany to their globally competitive levels. The plan thus reflected the new economic position of Germany and Japan in the world of the 1970s and asked them to share the

[103] Ibid
[104] Ibid

burden of stimulating the global economy from which they had benefited from over the last twenty years.[105]

This locomotive strategy therefore carried huge potential. If successful it could have built the foundations for a new multilateral economic order, one that was centred on a growth platform where the strongest economies provided the demand to grow that of the weaker ones, raising global aggregate demand in the process. Unfortunately however, the strategy failed. The governments of Germany and Japan refused to initiate domestic expansion to the level that was necessary, fearing that the increase in the domestic costs of production would inflict a further blow upon their cost-competitive export strategies, on top of the one already received through the revaluation of their currencies at the beginning of the decade. In consequence, "[a]lthough the rhetoric retained a commitment to cooperation, the policy became one of pursuing a unilateral expansion" within the United States.[106]

The Carter administration received substantial foreign inflows to finance its stimulus program, largely from the central banks of Japan and Germany, who purchased the release of new dollar-denominated assets in order to appreciate the value of the US currency compared to that of their own. Foreign financing of the dollar received additional impetus in the second half of the 1970s with the added input of the OPEC countries, who "were also major defenders of the dollar in this period because both the revenue from oil exports and a large proportion of their assets were denominated in dollars".[107]

As a result, the unilaterally pursued expansion proved highly inflationary within the domestic economy of the United States, as the growth of aggregate demand failed to match the economy-wide rise in prices. As it had in the late 1960s, these inflationary conditions proved unattractive to international investors and capital began once again to flow out of the United States towards the more competitive economies of the other advanced capitalist nations. In consequence, the dollar experienced another series of devaluations, which at the time generated considerable political controversy for the Carter administration amongst its domestic constituency.[108]

[105] Helleiner, *States and the re-emergence of Global Finance,* P.131
[106] Ibid
[107] Ibid
[108] Ibid pp 131-132

According to Barry Eichengreen, the Carter stimulus package was implemented "with full knowledge that its inflationary effects would weaken the dollar".[109] The administration however hoped that the German and Japanese authorities would pursue similar expansionary policies, thus reducing the incentive for speculative flows. Mutual adoption would significantly reduce the incentives for speculative flows from one economy into another in order to exploit exchange rate differentials, as the basic conditions between the three economies would all remain roughly the same. As we have seen, this hope ultimately proved ill-founded, a factor that was to have grave political consequences for the Carter administration back home. Among its domestic constituency, the administration's policies were accused of exacerbating the stagflationary tendencies prevalent throughout the country's economy. This was a verdict that held considerable truth, owing to the intensification of competition inside the United States as the two other internationally dominant nations failed to contribute to the task of raising global aggregate demand.

The failure of Carter's locomotive strategy ultimately paved the way for the political popularity of the simplistic supply-side solution of the Reagan administration. However, unlike the Carter strategy, the Reagan solution held no basis in economic sensibilities. As such, its implementation introduced an ideological redirection into American society. This would prove to be a redirection that would heavily favour the financial sector at the direct expense of America's real productive economy. Economic redirection was enacted despite the fact that over the last thirty years of comparatively impressive growth levels, the American economy had overwhelmingly based its economic advancement on this productive sector. The era of financialisation had begun.

Conclusion

In conclusion, the domestically oriented planning system of the American economy suffered a serious disruption from the incursion of cheaper foreign competition beginning in the 1970s. The economic issue of 'stagflation' that emerged shortly thereafter is commonly cited as an empirical indictment against the effectiveness of Keynesian policies. In turn, the popular acceptance of this indictment paved the way for the ascension of the neo-classical school of economic thought, along with the supply-side policies that this theoretical position has ultimately inspired.

[109] Eichengreen, *Globalizing Capital*, P.141

In contrast to the neo-classical position, this paper argues that the emergence of 'stagflation' does not signify the empirical redundancy of the Keynesian tradition per se; rather it identifies the problems associated with the application of domestically-oriented demand management policies in the context of an unfettered international environment. The series of Keynesian stimulus packages implemented by the federal government throughout the decade of the 1970s did serve to stimulate a national economy (indeed they served to stimulate several); the problem was however, that none of these stimulated economies happened to embody that of the United States itself.

The primary causative factor behind the stagnating tendencies of American industry during the 1970s was the influx of cost-competitive imports that undermined the normative regime of the planning system to refrain from engaging in aggressive price-based competition. It was this complicit agreement that had ensured that the high-road economic model of the planning system would generate the required revenue that enabled American corporations to engage in long-term productive investment projects. The stability of the planning system therefore was effectively undermined by the incursion of price-aggressive foreign competition.

In consequence, the lowering of interest rates by the American government as a means to inspire a credit-induced recovery of its stagnating economy failed to encourage US manufacturers to re-engage in productive investment projects, due to the fact that the ability to generate a return on any productive investment in this period was markedly reduced by the ability of foreign competitors to undercut American producers within the United States' consumer markets. As such, the lowering of interest rates by the Federal Reserve at this time merely induced an expansion in American consumer's ability to spend through increased credit. This enabled all suppliers within the US market – both foreign and domestic alike – to raise their prices, thus leading to price inflation.

However, because the market share of American producers had been radically reduced by the incursion of foreign competition, these price rises were unable to generate sufficient revenue for American companies to once again engage in long-term productive investment projects. Thus we have the emergence of an inflationary economy that does not have the corresponding economic growth (in terms of an expansion in investment, employment and wages) to accommodate these price rises, as had occurred in the previous planning system. It is for this reason why price inflation became a major problem for the American economy during the 1970s.

An inflationary economy meant that American producers now faced an increase in the price of intermediate products, which in turn increased their overall cost of production. The incursion into their markets by foreign competitors however, meant that they were not able to correspondingly increase their profits in order to cover these rising costs as they had done during the planning system. This resulted in the stagnation of American industry.

Their foreign competitors however, initially did not share this same inflationary problem in a rising cost of production, due to their national export-oriented strategy of suppressing domestic demand in order to ensure the price-competitiveness of their products inside the US consumer markets. They were thus able to raise their prices in line with the American market, but still to a level that was able to undercut American producers, since they did not face the same level of production costs as the American manufacturers did through inflation. It is for this reason why these foreign competitors became the primary recipients of the American government's Keynesian demand stimulus packages. This is clearly evident from the growth in their economies during this period, compared to the decline of growth experienced by the US economy in this same time frame.

The expansion in consumer credit that was fuelling the rise of inflation in this period experienced a further boost in growth via the emergence of another international development. The rise of the Eurodollar market provided an unregulated source of funds for US banks to draw on, in order to evade the lending restrictions imposed by the Federal Reserve as a means to halt the spread of inflation throughout the American economy. The Eurodollar market provided a way for West Germany in particular to purchase US dollars, in order to keep its own currency down relative to the dollar– along with the price of its exports – and then loan these purchased dollars to the US financial sector via the unregulated international intermediary of the Euromarket. This therefore enabled US banks to increase their lending throughout the American economy, thus providing the consumer credit that was fuelling the problem of inflation within the United States at this time.

The breakdown of the Bretton Woods system and the ensuing intergovernmental agreements led to a devaluation of the US dollar, which led to an increase in the price-competitiveness of US products and a brief turnaround for the American economy. This turnaround however was based on an increased role for exports in generating economic growth for the United States' economy than had previously been the case. In turn, America's industrial competitors took steps to further reduce their own domestic demand, in order to generate cost-effective conditions of production, to compensate for the increase in price of their exports from the revaluation of their currencies. This however worked to further depress the conditions of global aggregate demand, exacerbating the initial problem that had instigated the emergence of 'stagflation' in the first place.

The Carter administration attempted to address the issue of insufficient aggregate demand at the international level through its 'locomotive' strategy. The inadequate implementation of this strategy by West Germany and Japan however, led to the failure of this global growth stimulus strategy. As such, the full implementation of this strategy by the United States alone proved to be highly inflationary for the US economy, as the stimulus package was ultimately undermined by the undercutting activities of foreign competitors, as had occurred throughout the 1970s. This discredited the political viability of the 'locomotive' global growth strategy and paved the way for the ascension of the neo-classical position, along with the subsequent financialisation of the US economy.

What this all calls into question therefore, is the assertion made by orthodox economists today that Keynesian theories of demand management are no longer relevant to the current debate. What seems to have been more of an issue in the 1970s was not domestic Keynesianism per se but rather the unfettered international environment that had undermined domestic Keynesianism in the first place. Keynesian policies proved an effective policy tool in stimulating national economies after the last great global depression in the 1930s. Perhaps rather than Keynesian policies being discarded by conventional policymakers, the unregulated nature of the international environment is looked at more closely and solutions are reached that aim to address this debilitating international environment. For as we shall see in the following chapter, the neoliberal laissez-faire solution, as practised in the United States throughout the 1980s and 1990s, only worked to establish a financialised economy based on speculation, which in turn encouraged a serious decline in the country's productive sector, along with the emergence of a low road employment model.

Today solutions need to be reached that avoid the establishment of these debilitating conditions. More than simple regulation in the financial sector needs to be introduced. Fundamentally, what is required is a move away from financialised growth back towards a productive-based system, similar to the one that was practised during the

Golden Age period. What this Chapter has shown is that the neoliberal assertion that the Keynesian planning system of growth was responsible for the emergence of 'stagflation' in the 1970s is based on fairly shaky ground and other explanations are available. The current debate needs to be expanded to include these alternative perspectives if an effective solution (rather than a temporary stop-gap measure) is to be reached to grow the global economy out of its current predicament.

Chapter 3: Financialisation

Introduction

The perceived failure of the Carter administration's attempt to expand global aggregate demand through its 'locomotive' strategy, paved the way for the ascension of neo-classical theories of economic development within American policy-making circles. This school of thought was heavily focused on the overall efficiency of an economy. It was thus implemented in American policy-making circles as an attempt to improve the country's competitive conditions of supply, in order for American producers to become more competitive against the cheaper prices of its primary competitors.

The following chapter will provide an analysis of the practical outcome of the initiation of these supply-side policies. This will be employed as an argument against the continued application of neoliberal policies as the preferred policy response to the current recession. The chapter will trace the development of the process of 'financialisation' during the 1980s and 1990s, a direct outcome, it will argue, of the pursuit of neoliberal supply-side policies throughout this period.

The chapter will begin by analysing the impact of the 'Volcker Shocks' - the imposition of high interest rates by the Federal Reserve - on the structure of the US economy. It will be argued that the imposition of these high interest rates ultimately worsened the situation of the American economy. As the rise in interest rates inspired an appreciation of the US dollar on the world's currency markets, it exacerbated the problem of profitability for the country's tradable sector against the influx of cheaper-priced foreign imports. The following section will explore the theoretical roots of this high interest rate policy, namely the theory of Monetarism put forth by the neo-classical economist Milton Friedman. This section will show how the theory of Monetarism was largely formulated in opposition to the Keynesian theory of demand-management.

The next section of the chapter will analyse the supply-side policies put in place by the Reagan administration. It will be argued that these policies worked to redistribute resources and power away from Labour and America's middle class towards the holders of wealth within the country's financial sector. The economic environment that emerged under these polices led to the rise of the 'corporate raider'. This will encompass the focus of the following section. The chapter will argue that the rise of the corporate raider was a response to the economic conditions of the time, where there existed large amounts of liquidity within the financial sector but no profitable outlets within the productive sector through which to invest this financial capital in. The rise of the raider constituted the first phase of the economic process of financialisation.

There did exist a brief attempt to revert the process of financialisation inside the United States economy and achieve growth through the country's productive sector. The next section of the paper will examine these efforts, in particular focusing on the attempt made by Treasury officials in the mid-1980s to address the problem of the high dollar, which was then stifling the profitability of the country's productive sector. These officials organised a diplomatic solution to the problem through the formulation of the Plaza Accord. This diplomatic effort achieved a measure of success, but was ultimately undermined by international developments that occurred outside the orbits of the Accord's agreements.

The next section of the chapter will analyse the second phase of financialisation inside the US economy. This second phase involved American corporations themselves adopting the short-term sharemarket appreciation strategy of the corporate raiders. The chapter will show how this second phase of financialisation was assisted by the re-orientation of corporate management incentives during the 1990s. The chapter will argue that this second phase of financialisation was extremely destructive for the country's productive sector and worked to divorce the profitability of American firms from the conditions of the country's real economy, thus leading to the speculative sharemarket boom of the 1990s.

The remainder of the chapter will analyse the ways in which this process has impacted upon the productive capacity of the United States economy. This section will examine the ways in which this process has led to the rise of a number of structural factors inside the American economy, which together have encouraged the institutionalisation of a low-wage economy. It is this development that constitutes the primary problem of the United States economy into the twenty-first century, and is one of the major factors preventing an effective recovery from the current recession.

The 'Volcker Shock'

The redirection in Federal Reserve Monetary Policy following the appointment of Paul Volcker as Chairman of the Federal Reserve Board on October 6 1979 was in many ways the preeminent turning point in US post-war economic history. It was largely from this point on that the United States turned away from an economy where growth was based primarily in the productive sector to one where financial market activity came to constitute the preeminent source of profitability for American companies. As we saw in the previous chapter, at the time of Volcker's appointment, the US economy was beset by two seemingly contradictory set of circumstances: industrial stagnation occurring simultaneously alongside an overheated (inflationary) economy. The preferred policy response to these two particular problems generated considerable debate amongst the academic community. In particular, debate revolved around which of the two problems should receive policy priority by the Federal Reserve in its efforts to maintain macroeconomic stability: industrial stagnation or price inflation.

As we have seen, the conventional Keynesian solution to stimulating growth within a private sector beset by stagnating industries was for the government to directly pump money into the economy, via either increased fiscal spending or loose monetary policy. This injection of liquidity works to expand aggregate demand for the goods and services sold within the domestic economy, increasing business profitability and thus putting productive industry back on a upwards track of economic growth. In direct contrast, the monetarist response to high inflation was to target the liquidity function of the money supply. This process involves instituting measures designed to reduce the amount of money circulating throughout the economy, namely through an increase in interest rates. This encourages increased household saving, which in turn reduces consumer spending within the economy. Consequently, with more money tied up in household savings, producers are pressured to lower their prices if they wish to sell the same number of units within the economy, as consumers forego their previous levels of spending due to the higher returns to saving found within the financial sector. In this way prices on the supply curve are lowered in order to meet the reduced spending limits exercised on the demand curve. As a result, the inflated economy is brought back down to a position of macro-economic equilibrium, thus addressing the problem of inflation within the economy.

The problem however, is that this monetarist anti-inflationary strategy, with its emphasis on the demand curve as the ultimate source of pressure on producers to lower their prices, inevitably has a dampening effect on the level of aggregate demand that exists within the macro-economy. As a result, if implemented during a period of economic slowdown, this strategy will invariably impose a strong hindrance upon the ability of private enterprise to overcome its industrial inertia, as the economic environment is one that encourages saving not the consumer spending that is necessary to increase sales and restore profitability. This therefore exacerbates the problem of stagnation for the private sector, a problem that constituted one of the major problems of the American economy in the late 1970s.

It was therefore clear that if implemented, the two opposing theoretical solutions would produce conflicting outcomes, heightening the problems experienced by the American economy. A clear choice thus existed for the country's economic authorities in regards to which of the two problems to address: price inflation or industrial stagnation. Initially an attempt was made to revive industrial growth under the Carter administration's locomotive strategy. However the perceived economic failure of this strategy provided an empirical basis for the monetarist position to push forth its own policy platform. This was achieved by the rapid redirection in Federal Reserve monetary policy under the leadership of Paul Volcker.

Michael Mussa, a member of the Reagan Council of Economic Advisers provides a poignant account of the rapidity of the changes in Federal Reserve monetary policy under Volcker. Mussa states that on the "Saturday" of his appointment, Volcker immediately increased the Federal Reserve's discount rate - the rate it charges for overnight lending to the banking sector –a full percentage point "to a new record of 12 percent".[110] The Federal Reserve's discount rate has a huge influence on the rates of interest found in the financial markets, as this is the interest rate private banks must pay to borrow for overnight lending from the Federal Reserve in order to clear up any imbalances left over amongst themselves after the day's trading.

As such the discount rate of the Federal Reserve largely sets the rates of interest charged by banks in the private sector. Indeed this was clearly evident after the first initial raise in interest rates in October 1979. According to Mussa, the "financial market response to the new Federal Reserve policy was immediate and dramatic. On the following Monday, the short-term interest rates leapt upward".[111] Interest rates set by the Federal Reserve would continue to rise into the first two years of the 1980s. "During

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[110] Michael Mussa, 'Monetary Policy' in Martin Feldstein (ed) *American Economic Policy in the 1980s*, Chicago: University of Chicago Press, 1994, P.96

[111] Ibid P.97

the seven weeks following the presidential election, the Federal Funds Rate [the discount rate] was driven up 6 percentage points, to nearly 20 percent by mid December 1980".[112] Indeed, from November 1980 through to October 1981, the "Federal Funds Rate was kept above 15 percent, half the time in the range of 18 to 20 percent".[113]

The high interest rates pursued by the Federal Reserve clearly favoured the financial sector over that of America's productive enterprises. Under the inflationary period of the 1970s it had proved extremely difficult for the financial markets to generate a profit. Due to the rapidly rising rate of inflation during this period, lenders had become increasingly frustrated in their efforts to establish an interest rate that was both attractive to borrowers at the time of the loan's origination, while also being able to maintain a interest rate that was consistently higher than the rate of inflation throughout the loan's duration. Thus with high rates of inflation steadily eroding the purchasing power of money, interest rates had failed to keep pace with the rise of inflation, leading to zero or negative returns for those who lent money out into the economy. In this regard, inflation was clearly more disruptive to the financial sector than it was to the country's productive enterprises, who, as we have seen in the analysis of the post-war planning system, were able to tacitly coordinate prices amongst themselves in order to pass on rising costs of production to their consumers, who in turn were able to demand higher wages to cover the rising costs of consumer items.

From the perspective of the planning system, a rising floor for consumer prices within the United States' domestic economy was in fact a positive development for the nation's producers, who had previously experienced a dramatic deterioration in their ability to mark-up prices over costs due to the rapid influx of lower-priced imports into their respective markets. A rising price floor through inflation was enabling American firms to increase their mark-ups once again, in order to recover some of the revenue lost through the incursion of aggressive price competition by foreign producers. Over time, it is highly likely this mark-up recovery would have enabled firms to generate the required revenue to once again initiate internally-driven long-term productive investments. It was these investments that carried the capacity to enable American producers to regain commercial competitiveness through the innovative production of advanced industrial goods, in the process speeding up the technological obsolescence of their foreign competitors inside the US consumer markets.

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[112] Ibid P.104
[113] Ibid P.107

Consequently, the conventional means of relying on internal revenue to fund long-term productive investments meant that for productive enterprises, an inflated money supply was not a disastrous outcome. Profitability for these firms was generated from the initiation of productivity improvements or the commercialisation of innovative new technologies, not on passively holding money within their corporate coffers. Indeed the benefit to borrowing under the inflationary conditions of the 1970s was not necessarily a bad thing for America's productive industries. With low-cost foreign competition inhibiting the ability of US firms to earn the required revenue to engage in productivity-improving long-term investment projects, the highly favourable inflationary-induced conditions of borrowing could have provided them with a source of low cost capital, which could have enabled them to quickly re-engage in their long-term investment strategies, thus countering low cost foreign competition through greater productivity in their industrial manufacturing.

However the initiation of high interest rates inside the United States prevented the possibility of such an industrial strategy from being adopted by the nation's productive firms. The combination of high interest rates, in association with the country's newly deregulated financial markets, proved highly attractive to international investors looking for a lucrative location to invest their capital in.[114] In consequence, a considerable sum of capital left the Eurodollar markets in favour of the higher returns offered by the elevated interest rates inside the United States. This exponentially increased the international demand for the US dollar, which in turn radically appreciated its exchange rate on the foreign exchange markets.

For America's productive enterprises, this increase in the international valuation of the dollar on the foreign exchange markets dramatically exacerbated their problem of having to compete against lower-priced imports inside the country's consumer markets. Due to the appreciation of the dollar, the cost of the imports inside the United States were now rendered even cheaper, as the currencies of the countries where these imports originated from were now considerably cheaper than the exchange rate that prevailed for the US dollar.[115] In summary, the US financial sector was boosted by considerable funds from foreign investors looking for a place that generated high returns for their capital. This however increased the demand for the US dollar on the foreign exchange markets, raising its price and in the process undermining the competitive conditions of

[114] Jeffrey A. Frankel, 'Exchange Rate Policy', in Feldstein *American Economic Policy in the 1980s*, P. 296
[115] Robert Kuttner, *The End of Laissez –Faire: National Purpose and the Global Economy After the Cold War*, New York, Knopf, 1994, P.88

the country's tradable sector. Notably, this included the country's manufacturing industries, which at the time constituted the primary driving engine of the US economy.

As a result, the "Volcker Shock" - the imposition of excessively high interest rates - culminated in a severe contraction of the US economy. During the "deep and prolonged recession" that lasted from 1980 to 1982, "GNP would fall absolutely by 3.3 percent and the unemployment rate would rise to a postwar peak of 10.8 percent". With their competitiveness now even further undermined inside their home market by the dramatic appreciation of the dollar, many manufacturing firms either went bust or laid off staff and reduced their productive output. This further reduced aggregate demand throughout the economy, weakening demand in the domestic market for their goods, which in turn resulted in more redundancies, in the process precipitating a self-reinforcing recessionary cycle.

Keynesianism Vs Monetarism

In order to understand this policy development it is important to analyse the academic debate that lead to the ascension of the monetarist position. As we shall see, it was the practical implementation of this theoretical assumption that largely fuelled the financialisation process inside the United States economy. As such, if a full understanding of the financialisation process is to be achieved, a clear comprehension of the underlying theory is essential. This theoretical analysis is especially essential for an understanding of the financial crisis faced by the United States today. Conventional analyses of the current crisis are shaped by the monetarist position that gained ascension during the late 1970s. The historical foundation of this theoretical paradigm therefore needs to be analysed in order to determine whether the orthodox policies of today are indeed effective solutions to the contemporary crisis, or whether in fact their application in the past was one of the key contributing factors to today's financial recession.

The theoretical backdrop underpinning the Federal Reserve's high interest rates in the early 1980s was the monetarist position championed by the neoclassical economist Milton Friedman. Friedman employed his monetarist theory as a critique against the Keynesian-inspired fiscal spending that had been pursued by successive governmental policymakers throughout the post-war period. The crux of Friedman's critique rested on the assertion that "inflation is always and everywhere a monetary phenomenon". As such Freidman attributed the cause of inflation to an excessive expansion in an economy's money supply. ("To control inflation", Friedman had argued, "you need to control the money supply").[116] This excess constituted an expansion beyond that which was 'naturally' produced by the private-sector market economy. In this regards, the 'natural' rate of the money supply was that which was directly generated by the market mechanisms of supply and demand, which if left unhindered by external forces (such as the government) and thus enabled to achieve economic equilibrium, would produce the natural rate of growth for an economy's money supply. According to this argument, government spending, as an initial injection of liquidity in order to stimulate a stagnating private sector, generated an over-excessive expansion in an economy's money supply. It was this excessive monetary expansion, Friedman argued, which had enabled producers to raise their prices above what the 'natural' level should have been in the markets, thus generating an inflationary economy in the process.[117]

Friedman's theory on monetarism was essentially a rehashing of the classical assumption of "Say's Law", a "law" that had already been largely discredited by Keynes in his *General Theory of Employment, Interest and Money*.[118] The contemporary scholars William Mitchel and Joan Muysken claim that "[n]othing really changed in the modern statement of monetarism that had not been shown to be deficient, albeit in different terms, by Keynes and others".[119] It is therefore important to examine the empirically flawed argument of this classical "law', in order to identify the deficiencies with Friedman's contemporary position.

According to Says "Law" whatever was spent within the economy was earned again. It was this "law" that in theory enabled a position of economic equilibrium to be reached between the market mechanisms of supply and demand. Over the long term, according to Says Law, the output costs of production would match the input gains or profits collectively made by private companies. Keynes however argued that this law of equilibrium was in fact nothing more than an economic fallacy. He pointed to the prevalence of personal savings rates in what he called the "paradox of thrift" to illustrate his case. Keynes argued that not all the capital that firms spent on wages and salaries was put back into the economy in order to purchase the goods and services sold by

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[116] Milton Friedman and Anna Jacobsen Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton: Princeton University Press, 1963, P.559
[117] Geoffrey Ingham, *Capitalism*, Cambridge: Polity Press, 2008, P.78
[118] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, 1936, P.30
[119] William Mitchel and Joan Muysken, 'Full Employment Abandoned: Shifting Sands and Policy Failures', in *International Journal of Public Policy*, Vol. 5, No.10, 2010, P. 47

business in the consumer markets. This was because individual workers chose to save a portion of their earned income. As such, this saved portion of personal income was removed from the consumer economy and thus represented a consistent barrier against the emergence of economic equilibrium, where output costs match input profits, as asserted by Says Law.[120]

Keynes showed how the higher the rate of savings by individual households, the less demand there existed in aggregate for the goods and services produced within the economy. If savings as a proportion of income reached especially high levels - what Keynes described as 'hoarding' – in response to, say, for instance, an onset of recessionary conditions, which encouraged households to save more of their earned income in order to provide them with enough capital to get through the hard times ahead, then this would further reduce the degree of aggregate demand found within the economy. In turn, Keynes argued, this decrease in demand would result in reduced profitability, encouraging layoffs and the further entrenchment of the recessionary conditions.[121] As we have seen, Keynes' solution to this situation was for the government to step in and fill the fall in aggregate demand through its own fiscal spending.

One of the great revolutionary insights of Keynes *General Theory* was the author's conception of the macroeconomy. It was here where Keynes demonstrated how the best course of action taken at the micro level of the individual firm does not necessarily translate into the best case scenario for the economy as a whole.[122] In this respects, the ascendancy of Keynesian theory signified a massive departure from the conventional analysis contained in the classical paradigm. Economists working under the assumption originally postulated by the classical progenitor Adam Smith, believed that the most efficient results at the aggregate level were produced by each market player doing what was individually in their own best interests. Smith had argued that "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner but from their regard to their own self-interest".[123]

Classical economic theory therefore was heavily constrained in its analysis of economic recessions, primarily through the preconceived assumption that what was most efficient at the micro level was also the most efficient at the macro level. Periods

[120] Ingham, *Capitalism*, P.78
[121] Keynes, *The General Theory*, P.144
[122] Ibid
[123] Adam Smith, *Inquiry into the Nature and Causes of the Wealth of Nations*, London Dent 1953, P.97

of economic downturn were thus attributed to natural fluctuations in the market, an analysis that largely ignored how actions taken at the micro level could exacerbate such situations, while also exempting the possibility of human action to mitigate such recessions. Indeed it was the inability of the classical paradigm to actively address the deep and severe downturn of the 1930s depression that lead to the application of the Keynesian prescription as an effective solution to that economic crisis.

In his analysis on the 1930s depression, Keynes illustrated how the most efficient course of action at the micro level – cutting back costs such as investment and employment – was actually worsening the economic situation at the macro level, as the culmination of cost-cutting activity across the economy curtailed the degree of aggregate demand that existed within the consumer markets. In consequence, efficiency maximising measures at the micro level were exacerbating the situation of low profitability that existed at the macro-level. In summary, during periods of economic downturn, the individual pursuit of self-maximisation does not collectively culminate in the most efficient employment of resources at the aggregate level, as classical (and today neo-classical) economists maintain. In fact, in this scenario, rather than being beneficial to all, it is in fact the inverse, mutually destructive for all concerned. The pursuit of individual self-maximisation – or rather self-preservation - during the 1930s depression, precipitated a down-ward spiralling recessionary cycle, which in the collective, constrained the business prospects of the nation's productive enterprises.

Despite the empirical economic recovery that was generated from the Keynesian recognition in the major flaw contained within the classical assumption of Say's Law, Friedman was able to reinstate the defunct classical doctrine by arguing that while Keynesian demand-management may prove successful in stimulating an economy in the short-term, in the long-run, the inflation that it generates will ultimately prove more harmful to the country's economy than the effects of the initial recession. In his seminal 1968 paper 'The Role of Monetary Policy', Friedman made the assertion that "[t]here is no long-run, stable trade-off between inflation and unemployment".[124] In making this assertion, Freidman was arguing that the inflationary pressures involved with Keynesian stimulus packages would eventually undermine the creation of the short-term employment generated through government spending.

[124] Milton Friedman, 'Role of Monetary Policy' in *The American Economic Review*, Vol.58, No.1, March 1968, P.11

Friedman's argument was based on the classical position that assumed a "neutral" role for money in the economy. Under this assumption, the growth of the money supply merely reflected the interaction between the market mechanisms of supply and demand, with the economic equilibrium between supply and demand generating the natural growth of the money supply, a similar proposition to the one theorised by Say's Law. In accordance with this view of monetary neutrality, Friedman argued that any government-induced increase in an economy's money supply is unable to achieve any real (inflation-adjusted) impact on the economy over the long-term, as it merely alters nominal prices and income in a "proportionate way".[125] According to the logic of Friedman, following the application of a Keynesian pump-priming measure, labour responds to the inflationary-induced increase in nominal wages by increasing its supply in the market. Firms on the other hand, carrying the logistical capacity to read the real signs of the market, realise that this nominal increase is inspired by inflationary pressures and thus do not raise their output accordingly. Eventually, Friedman argues, workers realise their 'error', in that the nominal rise in wages does not represent real gains but merely reflects inflationary expectations. They therefore reduce their supply to the market and as a result the employment figure falls back down to its "natural level". It is from this theoretically-defined 'inevitable' outcome that Friedman bases his assertion that in the "long-run there is no stable trade-off between inflation and unemployment".[126]

It was the ideological belief in this 'inevitable' outcome that led Paul Volcker to continue with his interest-rate shock treatment, even after the American economy had succumbed to a severe recession in the early years of the 1980s. Volcker himself stated that the "recession had begun in mid-1981, but we did not adopt a strongly expansionary monetary policy until the summer of 1982".[127] Why the enforced delayed reaction? Namely because the top priority of the Federal Reserve was not employment, industrial health, or indeed economic growth; it was inflation. This priority is clearly evident in Volcker's justifications for the tough actions of the Federal Reserve during these years. Volcker argued that "although the economy was in a recession, inflation had not fallen very much by early 1982" thus necessitating the need to maintain high interest rates.[128] Volcker obviously felt that the economic effects of continued inflation

[125] Ibid
[126] Ibid
[127] Paul Volcker, 'Monetary Policy' in Feldstein *American Economic Policy in the 1980s*, P.149
[128] Ibid

would ultimately, over the long-term, prove to be far more disruptive to the country's economy than the severe recession that at the time gripped the nation.

The Empirical Effects of Monetarism: Financial VS. Productive Growth

However it was the stubborn insistence on starving the productive economy from the essential liquidity required for American industry to grow its way out of the recession that ultimately proved to be the most disruptive for the long-term health of the US economy. As we have seen in the analysis of the planning system, the source of liquidity for long-term investments in the productive sector had traditionally come from revenue generated though sales made in the consumer markets. In the 1980s, this revenue was severely curtailed by both the domestic recession and the appreciation of the US dollar, which had undermined the competitiveness of American producers against foreign imports.

The high interest rates did however generate considerable liquidity inside the financial sector, as foreign capital flooded in to capture the high returns found in the country's financial markets. In this manner, due to the economic conditions established by the monetarist turn of the Federal Reserve, far greater returns could now be made through the sale of dollar-denominated assets in the financial sector rather than through sales made in the consumer markets for manufactured products. From this point on, financial-based profits came to constitute a growing component of corporate activity, as reliance on revenue gained solely through sales in the productive markets proved more and more of an untenable endeavour. Hence, with the benefit of hindsight, it is clear that the real threat to the long-term health of the American economy was not inflation, but in fact the anti-inflationary strategy adopted by the country's economic authorities. It was the imposition of this strategy that set the stage for the financialisation of the US economy, a process that has thus far proved highly unstable. Indeed, the crash of the 2008 credit bubble is merely the latest manifestation of this highly disruptive process.

A major flaw of the monetarist position is that it took no account of the empirical economic situation that existed in the post war planning system. In particular it failed to identify the important interconnections that existed between wages, prices and consumer demand within that system. In the planning system, the steady and coordinated increase in prices was matched by a steady and coordinated increase in wages. As a result, by increasing wages, firms increased households' disposable income and thus the aggregate demand for their goods within the country's consumer markets. In this way, inflation was kept in check with economic growth, for by paying higher wages, consumer demand continued to grow, enabling firms to maintain their established sales-track and thus continue to earn the internal revenue that was providing them with the capital to engage in long-term productive investment. Thus in contrast to Friedman's postulation that wage rises were inevitably inflationary, coordinated wage increases actually enabled the American economy to continue to grow, existing as an essential component in the growth of consumer aggregate demand that provided the financial stability (in terms of sales) for private firms to continue to engage in their productivity-improving long-term innovative investment strategies.

Therefore, in contrast to the monetarist position, wage rises were not a source of excessive inflation, disrupting prices and the efficient allocation of investment funds. Indeed, the small amount of inflation that did occur in this period was an essential component in the ability of Golden Age corporations to plan out and undertake long-term investment projects, financed as they were by internal revenue generated through sales in the nation's consumer markets. The simultaneous increase in both employment and wages during the twenty years of the Golden Age offers an empirical indictment against the Friedman assertion that workers would voluntarily withdraw their labour once they had 'figured out' that their wage rises were only 'nominal'. In reality, the technological advancement generated through productive investment ensured that there were real economic gains achieved during this period. As we have seen this investment was highly contingent on the ability to maintain sales in the country's consumer markets. The increase in both wages and employment during this period ensured that consumer demand would continue to grow, in order to accommodate the sales required to finance this productive investment.

The Institutional attack on Labour

Friedman argued that there was a "natural" level of unemployment for any given economy. Any attempts by a government to redress unemployment beyond its natural level would invariably, according to Friedman, be inflationary. This ideological assumption became established in US policy-making circles through the formulation of the NAIRU index, (the Non-Accelerating Rate of Unemployment). The NAIRU index calculated a 'natural' level of unemployment beyond which any attempts to decrease unemployment past this point would inevitably prove inflationary. The adoption of this index reflected an ideological shift in American policy-making circles. Rather than Keynesian demand management being used as a means to increase employment, emphasis was now placed on improving the supply of labour, notably its efficiency, in order to improve cost-competitiveness against the United States' cheaper commercial rivals. Under this ideological imperative, the position of labour was to be readjusted to become more malleable with the interests of the free market. The imposition of this ideological belief in governmental circles exacted a tremendous toll on the significant gains the labour movement had made during the first twenty years of the postwar period.[129]

The Volcker Shock constituted the first regressive undermining effort against the position of labour within the US economy. Here the redirection in Federal Reserve monetary policy clearly favoured the economic position of financial capital over that of labour. By placing primary importance upon inflation reduction at the expense of employment, labour became the lamb that was sacrificed in order to restore the profitability of the financial sector. Historically high interest rates were implemented by the Federal Reserve, as the new governing authorities believed that the country's money supply had been unnaturally expanded by twenty years of Keynesian fiscal spending, particularly after the expansion in social welfare spending under President Lyndon Johnson's 'Great Society' programme during the 1960s. In addition to this 'correction' in the money supply, it was believed that suitable measures had to be taken to address the structural factors that had enabled this 'unnatural' growth to occur. This task was enthusiastically adopted by the incoming Reagan administration, a bastion of the neo-classical school of economics. Under this new ideological initiative, Keynesian demand management policies were deemed inflationary. It was now up to the United States to improve its conditions of supply, or so the ideologues believed, if it was to establish the economic foundations to achieve 'real' as opposed to 'inflationary' economic growth.[130]

The solution to increasing the competitiveness of American industry by the Reagan administration and the Republican Congress of the 1980s lay not in increasing R&D spending; nor for that matter in making infrastructural investments in order to improve the innovation and performance of the nation's productive firms. Such a strategy would arguably have enabled American firms to effectively regain competitiveness in terms of quality, utilising the country's established technological capacity, particularly its highly skilled workforce, to generate new and improved

[129] Mitchel and Muyskem, 'Full Employment Abandoned' P.12
[130] Ibid

products for the world and its domestic consumer markets. No, under the guiding force of the Reagan administration, America's competitiveness was to be achieved by enacting measures to reduce its cost of production, so as to put it on a more competitive footing (in terms of price) with its cheaper foreign competitors. It must be noted that at this point the greatest advantage America's foreign competitors had inside the United States market in terms of cost was that of their considerably lower exchange rates compared to that of the US dollar. As we have seen, this was a disadvantage that was largely self-imposed through the high interest rates set by the Federal Reserve. Nevertheless, the Reagan administration ignored these international imbalances and pursued an efficiency-inducing drive with the aim of decreasing the cost of production inside the United States.

One of the largest cost components of corporate production was labour. Of course the costs paid out to labour also played an important function in maintaining the domestic demand that had fuelled economic growth during the preceding Golden Age period. However the Reagan administration ignored this important demand function in favour of an economic system where financial profits would be achieved by undermining and reducing labour's cut of the economic pie. The Reagan administration established its attack on organised labour inside the US economy by setting a precedent in the manner in which it dealt with industrial disputes with its own public sector workforce. When aircraft workers represented by the union PATCO went on strike against unfair working conditions, Reagan responded by firing the workers and replacing them with temporary contractors. This signalled an end to effective government support for organised labour, and legitimised the application of similar action by private employers.[131] The subsequent adoption of this precedent by the private sector was documented by the labour historian Damon A. Silvers. According to Silvers, employers "used permanent replacements to break strikes across the industrial landscape in campaigns like International Paper, Hormel, Caterpillar, Continental and Eastern Airlines". In addition, Silvers argues that "PATCO was followed by the effective cessation of labor law enforcement by the NLRB [the National Labour Relations Board]". [132]

Effectively what the Reagan administration established with the precedent it set with PATCO, was a new political economy where labour was not recognised as playing

[131] Robert Brenner, P.195
[132] Damon A. Silvers, 'How a Low Wage Labor Economy with Weak Labor Laws Brought Us the Mortgage Credit Crisis', in *Journal of Employment and Labour Law*, Vol.29, No.2, P.459

a vital and important role in generating economic growth. Labour was redefined as a cost, not as a source of innovation and productivity, as it had previously been defined during the Golden Age period. As such, the new political economy established by the Reagan administration considerably disenfranchised the position of organised labour within the American economy. This disenfranchisement was followed by a massive drop in union membership throughout the 1980s. It is important to note here that union disenfranchisement preceded the drop in union membership. This is an important point to remember in the contemporary climate, where the solution to empowering the position of labour is often seen as simply one of increasing union membership. While increasing membership numbers is of course a highly worthy endeavour, the greatest barrier to the disempowerment of trade unions is a political economy where wage rises and increases to employment are perceived as inflationary and a burden to international competitiveness.

The Reagan administration subscribed to the neoliberal agenda that prescribed a 'trickle-down' source of economic growth. This ideological belief has driven American economic policy for the thirty years following the electoral victory of the Reagan administration and its practical implementation accounts for one of the fundamental factors behind the financialisation of the American economy. According to this 'trickle-down' theory, wealth initially needs to be concentrated at the top of the income spectrum in order to for there to be enough funds to finance new business endeavours.[133] The main problem with this approach however, is that it places too much emphasis upon providing funds at the top where the initial investment comes from and not enough on dispersing wealth in order to have a sufficient consumer market to purchase the products of the original investment. It is arguably the existence of a sufficient consumer market that determines whether the initial investment is profitable and thus commercially feasible. However with more wealth concentrated at the top and less available for consumption within the middle and lower income stratas, the ability for business to make enough sales in order to cover the initial investment is markedly reduced. This is a problem that is further compounded by the fact that the trickle-down theory assumes a greater role for shareholders and outside investors in financing new productive investment. As a result, there is a greater demand on the company to make increased returns on any new investment project, in order to satisfy the demands of its external investors. In this manner, with increased demands upon their profits by outside

[133] Michael Perelman, *The Confiscation of American Prosperity: From Right-Wing Extremism and Economic Ideology to the Next Great Depression*, New York, Palgrave Macmillan, 2007, P.103

investors, together with a reduced capacity for the consumer markets to purchase new products, the practical application of a ‘trickle-down’ investment model can actually act as a disincentive to undertake new productive investment initiatives, at least to the scale that was initiated under the planning system of the Golden Age period.

The Reagan Tax Cuts

Besides labour, the other excessive cost component the Reagan administration deemed to be curtailing the competitiveness of corporate America was taxes. Taxes were argued to constitute too high a component of corporate America’s annual expenditures and as such were cited as being one of the largest barriers to increased productive investment within the American economy.[134] This ideological belief however ignored the significant role the government played during the Golden Age period, of providing contracts for research and development throughout the private sector. These contracts were of course financed by tax-payer funds, so corporate America did in fact derive benefits from taxation and this taxation did spur innovative investment within private enterprises. As such, these government contracts served an important role in steering the American economy towards the production of advanced technological items, putting the country at a significant advantage in the world economy for a number of years. However, the supply-siders that dominated the Reagan administration believed that paying too much in taxes was holding corporate America back. What was required was a reduction in taxes across the board. It was argued that this would serve as a stimulus to kick the economy out of the recession the American economy was mired in at the beginning of the 1980s.

The tax cuts that were initiated by the Reagan administration were inspired by some extremely shaky economic theory. According to the economic logic of the supply-siders, the tax cuts initiated by the Reagan administration would ultimately pay for themselves. By enabling workers to take home more of their after-tax incomes; it was believed more people would be encouraged to enter the workforce. With more workers in the workforce, it was argued, there would be greater productivity and thus greater incentives to invest in the American economy. Moreover, with more people employed in the workforce, the federal government would now have more people to tax from. In

[134] Don Fullerton, ‘Tax Policy’, in Feldstein *American Economic Policy in the 1980s*, P. 173

this way while the individual tax burden would be reduced for American workers, the collective tax-take of the federal government would actually be increased.[135]

This supply-side tax logic stemmed from an extreme interpretation of the already suspect Say's 'law'. According to the supply-side interpretation, rather than supply matching demand as in the 'law' of Says law, supply actually creates its own demand. From a practical standpoint this is a highly illogical outcome. For why would an enterprise choose to employ more workers before the market demand for its products had expanded to a level to where the extra labour was needed? Certainly by increasing its workforce a business could increase its output as the supply-side doctrine maintained, but it would not be able to *make money* on this increased output unless there existed a sufficient and growing consumer market for its products. It is clear that a firm will never be able to *profitably* increase its supply to the market unless the demand for its output is growing and the business - in terms of actual sales - has begun to expand. In this respects, it is arguably clear that in stark contrast to the supply-side position, supply does not increase demand. In fact it is the inverse that is true: an increase in demand enables an expansion in supply to be commercially viable, thus ensuring that the economy expands in a sustainable fashion. Indeed this constituted the key logic behind the Keynesian stimulus measures. Here an increase in aggregate demand enabled private business to profitably expand its output of supply, in the process generating a self-reinforcing expansionary cycle. In attempting to politically discredit the empirically validated Keynesian formula, the supply-siders offered its inverse. The practical application of this inverted theory created numerous problems for the American economy, not the least of which was the explosion of federal debt following the initiation of the supply-side tax cuts.[136]

Supply-side logic argued that the Reagan tax cuts would ultimately pay for themselves. By encouraging more people to take up paid employment, the overall pool of taxable incomes would be enlarged. In this way while individual tax intakes were reduced, it was postulated that the government would be able to tax an enlarged number of individuals. This theoretical presumption however ignored the fact that unemployment in the 1980s was primarily structural, not voluntary as the supply-siders had claimed. In the early 1980s American companies were unable to expand employment in the face of a severe domestic recession, exacerbated by lower cost foreign competition that had been given a further boost by the high exchange rate of the

[135] Ibid, P.166
[136] James M. Poterba, 'Budget Policy', in Feldstein *American Economic Policy in the 1980s*, P.235

US dollar. No matter how willing individual workers were to join the workforce, in the prevailing economic climate, most companies could not afford to take them on.

The series of tax cuts implemented by the Reagan administration displayed a remarkable absence of foresight for a governing administration. According to the economist Paul Krugman, the logic behind the supply-side tax cuts was so suspect that it had very little following amongst the academic community at large, even among the most ardent advocates of neoclassical economics. According to Krugman "supply-side economics remained a tiny sect, whose ideas commanded the allegiance of only a handful of economists, most of the Republican Party, and the [then] President of the United States". Supply-siders "came from the fringes of economics: from journalism, from congressional staff positions, from consulting firms…They promoted their ideas not through papers in academic journals but in op-ed pieces and articles in semi-popular magazines like *The Public Interest*".[137]

A reading of articles written by academic neoliberal economists prominent during the 1980s confirms Krugman's observation. Martin Feldstein, the chairman of the Council of Economic Advisers (CEA) to the Reagan administration, claimed that while he "was convinced that there would be some favourable offsetting feedback effects of the lower tax rates on total revenue", was clear in his assertion that "the tax cut would definitely not be self-financing".[138]

In addition Feldstein offers an interesting insight into the President's own take on the supply-side tax theory. According to Feldstein:

> Although the President believed in the supply-side effects of lower taxes, I never thought that he accepted the extreme supply-side position that lower tax rates would actually increase tax revenue. He did make such statements in public announcements and press conferences, but I never recall him saying that in private discussions with senior administration officials; perhaps even if he once believed it, he no longer did by mid 1982 when I joined the administration. [139]

This observation offers an important insight into the interstices of politics and economics during the 1980s neoliberal revolution in economic policy-making. While

[137] Paul Krugman, *Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations*, 1994, P.85

[138] Martin Feldstein, 'American Economic Policy in the 1980's: A Personal View', in Feldstein *American Economic Policy in the 1980s*, P.25

[139] Ibid, P.21

Feldstein's observation is heavily based on speculation, it is nevertheless speculation undertaken by a man with detailed knowledge of the inside mechanics of economic policy-making within the Reagan administration. With this in mind, Feldstein's own admission that he never believed in the logic behind the supply-side tax cuts is particularly telling, especially since he was himself a prominent member in the administration that pushed through the tax cuts. The significant difference in Feldstein's political policy-making and his academic writing demonstrates a considerable contradiction in his work. However it is this key contradiction that gives us the greatest insight into the formulation of neoliberal economic thought that came to prominence during the reign of the Reagan administration.

It is clear in the above contradiction that political considerations took precedence over the academic concerns of the administrations principal economists. This is an important point that needs to be highlighted, not the least because it occurred in an administration that publicly championed the removal of political considerations from economic policy-making. During his campaign trail, Reagan had capitalised on the public frustration that had stemmed from the stagnation of income during the stagflation of the 1970s. Reagan campaigned on a platform that promised to reduce taxes and increase take-home incomes throughout America. It was nothing short of buying votes, made worse by the fact that the administration made no provisions to enable the tax cuts to become affordable into the future. Rather the Reagan administration relied on a bogus economic theory to explain away its 'ability' to achieve this. Clearly over the two terms of the Reagan administration, political promises took precedence over the formulation of effective solutions to the country's very real economic problems. This is clearly evident in Feldstein's admission, that the Party line "did complicate my subsequent job as CEA chairman in defending the tax packages as good economics despite its obvious failure to raise revenue".[140]

The Disproportionate Nature of the Tax Cuts

The tax cuts instituted by the Reagan administration disproportionately favoured those in the upper income spectrum. According to Krugman, citing a study which calculated the impact of all tax changes made during the 1980s on families at different levels of income, "a family in the middle of the income spectrum was actually paying a

[140] Ibid, P.25

higher share of its income taxes in 1989 than it was in 1980”. This increase in tax payments was due to the fact that for these middle income families “the increase in social insurance payments was more than twice as large as the fall in income tax”. In contrast, “a family in the top one percent of the distribution got a lot of tax relief, the fall in its income tax was twenty times as large as the increase in its social insurance payments. The overall tax rate on these high-income families fell from 36.5 percent in 1980 to 26.7 percent in 1989”.[141] For those in the lower income spectrum the cuts made to social services in order to finance the tax cuts ensured that their total losses from the so called tax cuts were even greater.

Along with those at the top of the income spectrum, those who earned income from financial market activity received a significant cut in the tax they paid to the federal government. According to Martin Feldstein, an “emphasis on saving and investment played an important part in the tax reforms of 1981”. This emphasis included: “strengthened incentives for business fixed investment through more rapid depreciation allowances; increased incentives to save through universal eligibility for individual retirement accounts; and an increased return on individual equity investments through lower rates of capital gains”.[142] In accordance with the ‘trickle-down’ theory of economic growth, it was believed that by increasing the tax incentives for wealthy individuals to invest in the economy, America would be able to recover economic growth, irrespective of the conditions of demand that existed within the country’s consumer markets.

As had been predicted, the promised tax cuts were not financially feasible and the federal deficit ballooned as a result. According to the economist James M. Poterba, “as a share of GNP, the federal deficit rose from 2.8 percent in fiscal 1980 to a peak of 6.3 percent for fiscal 1983”. For a measure of comparison “the federal deficit averaged 0.8 percent of GNP in the 1960s and 2.1 percent in the 1970s”.[143] This federal deficit had to be financed from somewhere and the federal government turned to the nation’s financial sector to provide the loans (through the purchase of government bonds) to finance its excess in spending. According to Feldstein, “interest payments on the national debt increased from 2.0 percent of GDP in 1980 to 3.4 percent in 1990”.[144] As

[141] Krugman, *Peddling Prosperity*, pp 155-156
[142] Feldstein ‘American Economic Policy: A Personal View’ in Feldstein *American Economic Policy in the 1980s*, P.16
[143] Poterba, ‘Budget Policy’ in Feldstein *American Economic Policy in the 1980s*, P.235
[144] Feldstein ‘American Economic Policy: A Personal View’ in Feldstein *American Economic Policy in the 1980s*, P.38

a result, a growing proportion of government spending was now directed towards the servicing of its debts to the financial community. In this way the financial sector earned a double whammy on the tax cuts it was provided by the federal government. As we have seen the tax cuts disproportionately benefited those in the upper income spectrum, along with those who derived income from financial market activity. These same individuals, as the greatest holders of wealth in the country, also held a disproportionate share of government bonds and thus were by far the greatest recipients of the interest the government paid out on its national debt. Thus not only did these individuals receive a large tax cut that the country could not afford, they also derived income from the interest on the loans they provided to the government, a possibility that was provided by the fact that the government could not afford to give them a tax cut in the first place. As such, it is arguably clear that the Reagan tax cuts were nothing less than a direct political redistribution of resources away from the bottom of American society to the top by the federal government. It was not - as was publicly proclaimed at the time - the efficient allocation of economic resources by the free market system.

The Rise of the Raider: Financialisation Part 1

With a stream of investment funds flooding into the United States in response to the rise in interest rates by the Federal Reserve, the country's financial sector was ripe with funds to invest in the US economy. The problem however, was that due to the rise in the dollar from this flood of foreign funds; the major manufacturing corporations were having a hard time making sales in their respective markets. As such they were extremely hesitant to undertake new investment projects, owing to the lack of consumer demand in their respective product markets. A few entrepreneurial individuals however began to devise means to capitalise on the increased access to financial capital, in a way that did not involve undertaking a commitment in physical productive investment. It was in this manner that the corporate raider and the leveraged buy-out movement of the 1980s came into fruition.

Corporate raiders were financial traders who borrowed massive amounts from banks and other financial institutions - who at the time were eager to lend and thus capitalise on their recently acquired funds – in order to finance their trading activity on the nation's sharemarkets. With borrowed funds, corporate raiders would target a company listed on the publicly-traded sharemarkets and then proceed to purchase a large amount of that company's stock in a short space of time. Stock purchasing would go on until the corporate raiders' collectively held a controlling interest – fifty percent or more – in that company's stock. With a controlling interest in the company, the raiders were now able to strip off and sell assets from the company balance sheet. The short-term spike in company profits from this sell-off would then appear on the listed stock exchange as a massive turnaround in profitability for the company concerned. This rapid boost in company profits inevitably sparked the interest of other investors, who would then begin to bid for that company's shares on the nation's sharemarkets. In turn, with more people now bidding up the price of that company's shares on the markets, the going price for that company's shares appreciates substantially. At the height of this share price appreciation, the initial raiders sell off their shares, netting for themselves a healthy profit from the inflated share price their financial dealings had inspired. Notably, this financial profit was achieved without having to undertake any measures at all to improve the company's actual production or long-term position.[145]

From the ideological standpoint of neoliberalism, these raiders were serving a useful economic function. One of the primary criticisms levelled at American industry by neoliberal theorists was that, compared to their leaner and more efficient foreign competitors, American corporations represented bloated bureaucracies, whose multitude of inefficiencies greatly inflated their costs of production. From the viewpoint of neoliberalism therefore, the rise of the corporate raiders was a positive development, enforcing efficiency measures within the corporations that were targeted in their strip and sell strategies. Corporate raiders were thus credited with playing a key role in improving the competitive conditions of supply for American industry. Indeed, the mere threat of takeover was enough to induce many companies to undertake efficiency measures of their own; reducing their production costs in an effort to boost profit margins - or what is called their price-earnings ratio - on the nation's sharemarkets. This increase in profitability would then lift the going price of the company's shares on the financial markets, rendering it more expensive, and thus more difficult, for the raiders to purchase their shares in a number large enough to initiate a takeover strategy.[146]

However, when the corporate raider movement is analysed from a more long-term macroeconomic perspective, it is clear that it was an extremely disruptive development for the industrial prospects of corporate America. The rise of the raiders

[145] Roger Lowenstein, *Origins of the Crash: The Great Bubble and its Undoing*, Penguin Press 2004, P.6
[146] Ibid

encouraged a move away from the stable and organised system of the productive planning system, towards a mode of business that was narrowly concerned with short-term financial prospects: what is now referred to as the economic model of financialisation. Because the profitability of the raider strategy centred on a financial investment that not only failed to increase the productive capacity of the company concerned (indeed it actually went a step further and decreased its productive capabilities by selling of company assets in order to shore up short term profit margins) it was in fact extremely destructive to the future productive potential of the United States of America.

The financial market manipulation of the raiders set in motion a trend throughout corporate America that divorced company profitability from the conventional processes of the planning system, where profitability was determined by long-term productive performance, which was utilised to generate sales within the country's consumer markets. This sustainable system was replaced by one where profitability was based on short-term asset appreciation within the financial markets. As this asset appreciation was largely achieved by undermining a company's productive capabilities, it was an appreciation that became increasingly divorced from the actual earnings of the companies caught up in this process. In the aggregate, this culminated in the establishment of an economic system where financial growth became divorced from actual material growth within the real economy. In consequence, the United States economy became progressively beholden to the whims of the financial markets, as it was the financial markets that were now largely driving economic growth during this period. It was no longer technology and innovation that were the essential components of economic growth, as had been the case in the planning system. Now economic growth was disproportionally determined by financial market manipulation.

Political Efforts Against the Financialisation Process

With the emergence of the corporate raiders, the era of financialisation had begun. Nevertheless by the mid 1980s, its hold had still not become firmly entrenched within the American economy. There still existed an active resistance against the trend, notably from the large manufacturing enterprises who were dominant during the planning system. These businesses were becoming increasingly frustrated – and vocal -

in their opposition towards the direction in which the American economy was taking.[147] The high dollar, while providing ample funds for the financial sector to manipulate prices on the national sharemarkets, was wreaking havoc upon the country's manufacturing and tradable sectors, as it was these businesses that still primarily based their profitability on producing goods and selling these in the country's consumer markets. Due to the considerable appreciation of the US dollar, American-based producers were being priced out of these markets by the cheaper products of their foreign competitors.[148] This problem of the high dollar persisted even after the Federal Reserve had brought interest rates back down in 1982.

At the time, one of the main reasons given for the persistence of the high dollar was the influence that the large federal deficit was having upon the expectations of international investors. Henry Kaufman, a prominent Wall Street analyst, at the time argued that the tax cuts the federal government was supplying were unsustainable and would inevitably give rise to a substantial fiscal deficit that would increase the economy's money supply and thus prove highly inflationary for the overall economy as a result. High inflation, he argued, would provoke the Federal Reserve to reinstate the high interest rates it had employed to effectively address inflation in the first two years of the 1980s. As such, even though interest rates had been lowered for the present, the prospectus of a large fiscal deficit would likely lead to a rise in interest rates in the future. As such, international investors continued to purchase dollar-denominated assets, in anticipation of this potential interest rate increase.[149]

This argument was widely cited at the time for the cause of the high dollar. However with the benefit of hindsight, it is also clear that the trend towards financialisation was also playing a prominent part in sustaining the interest of international investors' in dollar-denominated assets. The short-term share price appreciation strategy of the corporate raiders was fuelling a speculative boom in financial assets throughout the United States economy. As we have seen, the influx of investor funds into the US economy, following the imposition of high interest rates by the Federal Reserve, provided a large proportion of the credit the raiders borrowed to instigate their share price appreciation strategy. Since this strategy created a speculative

[147] Frankel, 'Exchange Rate Policy' in Feldstein *American Economic Policy in the 1980s*, P.322

[148] Robert Brenner, *The Economics of Global Turbulence: The Advanced Capitalist Economies from Long Boom to Long Downturn, 1945-2005*, London: Verso, 2006, P.195

[149] Russell Long 'Tax Policy' in Feldstein *American Economic Policy in the 1980s*, P.222

boom in asset prices within the American economy, international investors still had ample opportunities to make money on dollar-denominated assets, even after the Federal Reserve had brought interest rates back down to a more normal level.

Thus with the benefit of hindsight, we can see how the anti-inflationary strategy of the Federal Reserve had significant long-lasting structural implications for the US economy. The recession brought on by this anti-inflationary strategy starved the productive sector of required revenue, all in an effort to improve the fortunes of the financial sector. However with a productive sector mired in recession, the financial markets – now expanded through the influx of international funds - had no profitable outlets in which to invest their capital in. Consequently, they turned to other financial instruments as a means to appreciate their capital, and financial asset appreciation became the main means in which money was made in 1980s America. As this asset appreciation was primarily speculative-based, it generated impressive short-term profits for the financial sector. This attracted the interest of other international investors, who pumped even more funds into the US economy, in order to capitalise on the short-term gains to be made on the country's financial assets. In the process, this increase in international funds fuelled the financial liquidity that was enabling the speculative boom to sustain its pace into the 1990s.

By 1985 it had become clear that financial returns in the United States were widely divorced from productive performance. Productive firms were struggling to generate a profit under the high dollar; while the high dollar reaped in significant returns for financial investors. It was recognised that the divergence in financial growth from productive profitability was clearly a sign of a speculative bubble engulfing the American economy. This bubble was recognised by government officials and a number of initiatives began to be taken to redress this imbalance.

According to Feldstein, by "early 1985… the dollar had reached a level relative to the Japanese yen and the deutsche mark that could not be reconciled with the existing interest rate differentials".[150] By Feldstein's calculations the "value of the dollar had increased from 1.81 marks per dollar in 1980 to 2.55 marks per dollar in 1983, a rise of forty percent. The dollar also rose more than 50 percent relative to the British pound in this same brief interval".[151] The economist Jeffrey A. Frankel observed that at the time "[m]ost analysts considered the appreciation of the dollar (allowing for the usual lag of

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[150] Feldstein, 'American Economic Policy in 1980's: A Personal View', in Feldstein *American Economic Policy in the 1980s*, pp 84-85
[151] Ibid P.68

at least two years in trade effects) to be the primary cause of the subsequent deterioration of the US merchandise trade deficit, which rose $123 billion from 1982 to 1987”.[152]

This analyst consensus coincided with rising political activism amongst the tradable business sector for government intervention against the appreciation of the US dollar.[153] This activism found a supportive government body, largely achieved through a reshuffling of officials from the mid-1980s. Key in these new appointments was the change in leadership within the Treasury department, with James Baker and Richard Darman being appointed as the Secretary of Treasury and Deputy Secretary respectively, replacing the previous staunchly ideological leaders Don Regan and Beryl Sprinkel.[154] According to Frankel, writing on the new Treasury leadership: ‘both men had already developed at the White House a reputation for greater pragmatism than other, more ideological members of the administration”.[155]

In empirical support of this assertion, the new secretary James Baker took the political initiative in addressing the excessive appreciation of the US dollar. Baker began talks with government officials from the other G-5 economies of France, West Germany, Britain and Japan in order to find a diplomatic solution to the problem. During the ensuing negotiations, which took place over six months of private discussions, a signed agreement was reached which committed the central banks of the participating nations to actively intervene in the international currency markets, in order to raise the price of the yen and the mark in relation to that of the US dollar. The resulting agreement became known as the Plaza Accord.[156]

According to Frankel, “the Plaza had widely become considered a great public success”.[157] This success was judged on the merit that on “the Monday that the Plaza announcement was made public, the dollar fell a sudden 4 percent against a weighted average of other currencies (slightly more against the mark and the yen)”.[158] Robert Kuttner backs up this positive assertion, revealing that in the “first six months, co-

[152] Frankel, ‘Exchange Rate Policy’ in Feldstein *American Economic Policy in the 1980s*, P.294
[153] Ibid P.322
[154] According to Martin Feldstein, “Treasury Secretary Regan liked to argue that the high value of the dollar was an indication of the strength of the US economy and the high regard of investors worldwide for US economic policies”. In Feldstein, ‘American Economic Policy in 1980’s: A Personal View’, in Feldstein *American Economic Policy in the 1980s*, P.70
[155] Frankel, ‘Exchange Rate Policy’ in Feldstein *American Economic Policy in the 1980s*, P.303
[156] Kuttner, *The End of Laissez-Faire*, pp 92-94
[157] Frankel, ‘Exchange Rate Policy’ in Feldstein *American Economic Policy in the 1980s*, P.305
[158] Ibid, P.304

ordinated interventions by finance ministries and central banks spent almost all of the committed ninety-eight billion dollars and did succeed in driving the dollar down from 240 yen in September [1985] to 200 yen by the year's end and 180 yen in March 1986".[159]

Throughout the coordinated exchange-rate regime of the Plaza Accord the dollar continued to decline against the yen and the mark. "By mid 1987 it was below 150 yen and had lost half its value against both the yen and the mark".[160] This sustained decline in the dollar shows that the Plaza Accord achieved the objectives it set out to accomplish, highlighting the success of coordinated political action to address structural imbalances within the global economy. Left unchecked in the absence of government intervention, it is highly likely that the free market would have exacerbated the situation by progressively pricing the US productive sector out of the international economy.

A New Round of Global Price Depreciation

Nevertheless, despite the success in the coordinated devaluation of the dollar, the US trade deficit continued to grow "from $122 billion in 1984 to $134 billion in 1985, to $156 billion in 1986 and then declined only slightly to $146 billion in 1987. By 1990, it had more or less reached a plateau at close to $100 billion a year".[161] Thus while the Plaza Accord did have limited success in halting the expansion of the US trade deficit by bringing its currency more in line with that of its primary competitors, it was unable to adequately fix the imbalances that existed in the country's trade position and as a result its overall trade balance remained in deficit.

The reason for the failure of the accord in addressing the US trade deficit primarily lay in international developments that remained outside the orbits of its agreement. These international developments were generated from the emergence of the newly industrialising economies of south-east Asia, who arose as strong (i.e. cheap) competitors within the international manufacturing markets. As had happened with the emergence of Japan and Germany in the 1970s, the rise of these economies - based as they were on export-led growth - dramatically increased the supply of goods sold in the international markets, without adding much at all to the corresponding level of demand that existed within the global economy. This unleashed a fresh new round of global

[159] Kuttner, *The End of Laissez-Faire*, P.94
[160] Ibid, P.101
[161] Ibid, PP 101-102

price competition, an intensification that further undermined the United States trade position.[162]

The export dependent economies of the south-east Asian 'Tigers' experienced extremely rapid growth from the mid 1980s onwards. This economic development was largely fuelled by the massive influx of foreign direct investment from Japanese multinational corporations, who viewed production in south-east Asia as a means to counter the increased costs of their exports that had followed the appreciation of the yen through the Plaza Accord. By relocating labour-intensive components of production to south-east Asian nations, Japanese companies could make significant savings in production costs and thus lower the price of their products in the international markets, thus offsetting the rise associated with the appreciation of the yen. South-east Asian destinations were also used by Japan as a platform to launch exports into the United States, as a means to get around the "voluntary restraints" that had been put in place against Japanese imports by the Reagan administration during the 1980s.[163]

Japanese multinationals with subsidiaries in south-east Asia were further benefited by the fact that the currencies of the 'Tiger' economies were pegged to the US dollar. Thus as the dollar began to depreciate under the Plaza Accord, so did the currencies of the Tiger economies, and by extension, the production costs of Japanese multinationals who had outsourced production to the region.[164] According to Brenner, "Japanese banks supplied huge loans to Japanese corporations initiating operations in East Asia, as well as to East Asian businesses, and came to constitute the largest source of bank loans to every country in the region except Taiwan and the Philippines".[165] Through this influx of direct investment, the economic development of South-east Asia accelerated at a heightened pace. In the process, south-east Asian lines of production moved higher and higher up the value chain, to a point where they were able to compete directly against Japan and the other industrial nations on the world markets. The emergence of new competitors on the world's manufacturing markets induced a fresh new round of global price competition, a competition that was intensified by the low value of the new competitors' currencies, along with the low wages that prevailed in these countries. This worked to further depress the level of global aggregate demand, intensifying the pressures placed on productive producers inside the United States,

[162] Brenner, *The Economics of Global Turbulence*, P.190
[163] Ibid, P.221
[164] Ibid, P.226
[165] Ibid, P.285

accounting for the continuation of the country's trade deficit during this period. Nevertheless, despite this ballooning deficit, a number of US companies began to discover ways where this imbalance could be used to their advantage. They found this through embracing the process of financialisation.

The Financialisation of Firms: Financialisation Part 2

The continuation of the trade deficit was a clear sign that American industry was struggling to regain lost ground, not only in its international exports, but also importantly, in its own domestic markets. Through financialisation however, American industry found a way to regain commercial dominance despite the dramatic decline in the competitiveness of its productive sector. Indeed financialisation offered a way for American corporations to increase their profitability *through* the steady erosion of its underlying productive capacity.

Beginning in the late 1980s, a number of American corporations began to mimic the sharemarket strategy of the corporate raiders. Due to the great size of their companies however, they were able to initiate this strategy on a scale that far dwarfed that which was able to be exercised by the raiders themselves. What followed was the merger and acquisitions movement. This movement represented a key development in aligning the business strategies of the dominant corporations with that of the financialised business model. Employing their giant corporations as collateral, corporate executives borrowed from the banking sector and then proceeded to purchase the shares of their domestic competitors, to the point where they held a controlling interest in their rival's firm. Then through a process of strip and sell, the new managing directors proceeded to streamline the acquired firm's production processes in line with that of their own, thus increasing their firm's price-earnings ratio and boosting its short-term revenue streams.[166]

This strategy increased the financial earnings of the controlling corporation by two ways. Firstly, by eliminating one of its major rivals, the company could raise its future profit projections, heightening the interest of investors in its shares. Secondly, the reduction in production costs of the recently acquired firm – generated through the sacking of staff and selling off of company assets – translates onto the sharemarkets as a

[166] James Crofty, 'The Neoliberal Paradox: The Impact of Destructive Product Market Competition and 'Modern' Financial Markets on Non-Financial Corporations' Performance in the Neoliberal Era', in Gerald A. Epstein, *Financialization and the World Economy*, Edward Elgar Publishing, 2005, P.79

turnaround in the productive performance of the company concerned. This rapid turnaround was invariably attributed to the superior management capabilities of the controlling corporation by the financial analysts who reported on corporate performance. This turnaround thus signalled that the company's performance would be improved into the future, increasing its interest to sharemarket investors.

For the purposes of this paper, it is important at this point to pause and reflect on the long-term ramifications of this sharemarket strategy for the industrial health of corporate America. To begin with, despite the ideological aims of the supply-side reforms in increasing competition within the United States economy, the merger and acquisition movement that it inspired actually reduced the level of competition as it existed within the country's productive sector. As the bigger firms acquired the assets of their smaller commercial rivals, the number of domestic producers decreased, and so in turn did the level of competition that existed between American producers.

Deregulation and a greater access to finance were intended to intensify competition within the American economy. This was deemed necessary in order to break up the so-called inefficient oligopolistic market structure that had characterised business relations during the planning system. It was this oligopolistic structure, the neoliberal economic reformers argued, that had enabled industrial inefficiency to permeate the American economy, leaving US producers vulnerable to the cheaper prices on offer by its foreign competitors during the 1970s.[167]

In practice however, it was the financial markets, rather than the productive markets, where this intensified competition was carried out. From the late 1980s onwards, the financial arena of the nation's sharemarkets became the playing field where corporate dominance was determined within the US economy. Due to the threat of takeover and the loss of corporate control through the nation's sharemarkets, maintaining a consistently high price-earnings ratio became the top priority for American corporations. This short-term focus largely precluded the possibility of undertaking a financial commitment towards long-term productive investment. Such an investment would necessarily entail a number of short-term costs that would not be recovered until the original investment had generated a new product or a new productive process. The initial costs involved with the undertaking of such a strategy would therefore temporarily lower the price-earnings ratio of the company concerned. However in a highly liquid market such as the New York stock exchange, this

[167] Crofty, 'The Neoliberal Paradox', P.64

temporary decline would provoke a selling off of the company's shares by its financial investors, reducing the company's share price in the process. In turn, this reduced share price leaves the company highly vulnerable to takeover by a rival firm looking to capitalise on the short-term dip in the company's share price as a means to obtain a controlling interest in the company's assets at a low cost to itself.[168]

Thus in order to maintain commercial viability, an American corporation must make the maintenance of a high share price on the financial markets the number one priority - or bottom-line - of the firm. In doing so, the allocation of internal revenue towards innovative investments in long-term production – the pinnacle of growth under the planning system – ceased to function as a viable commercial strategy for corporate America.

One of the most effective ways of increasing short-term profits is to reduce operating costs. The easiest cost to decrease in the short-term is that of labour. This was achieved by reducing a company's workforce and designing ways to force the remaining staff to produce the same levels of output that were achieved prior to the cuts. It was this so-called 'efficiency' strategy that embodied management's most prevalent method of increasing 'productivity' during this time.[169] Indeed this was a strategy that proved particularly easy to implement in an economic environment where the position of labour had been greatly eroded by the federal government's attempts to construct a "flexible labour market," eroding labour laws so that labour would be more malleable to market forces, or rather workers would be more compliant to exploitation by their employers.[170] Mass redundancies as a corporate cost-saving measure were also indirectly encouraged by a monetary policy that targeted unemployment as a tool to counter rising inflation.

It is plain to see that the financialised strategy of stimulating economic growth operates in the entirely opposite manner to the Keynesian system of demand management. Under the Keynesian system, increased employment serves as a stimulus to demand. With more people working, more people are earning and with more people earning, more people are spending. The more people are spending in the economy, the more business is making, and the more business is making, the more funds it has to

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[168] Ibid, P.94

[169] Stephen L. Baglione, 'Employee Benefits and Work Conditions by Demographic Categories', in *Journal of the Academy of Business and Economics*, Vol.8, No.3, March 2008, P.19

[170] Catherine K. Ruckelshaus, 'Labor's Wage War', in *Fordham Urban Law Journal*, Vol.35, No.2, February 2008, P.373

commit to productive investment. In direct contrast, the financialised business model generates company profits through *unemployment*. By reducing its labour costs, a corporate enterprise is able to appreciate the prevailing price of its shares on the financial markets and through this achieve financial growth. However this financial growth is only able to be achieved by laying off productive workers, selling off productive assets and refraining from the initiation of any productivity-improving investment measures. In consequence, not only does the financialisation process depress aggregate demand and thus the capacity of the American consumer markets to purchase its products, it also erodes the productive capabilities of the companies engaged in its process.

In this financialised environment, the only real avenue available for a business to increase profitability is through the financial markets. However as we have seen, while the outgoing price for its financial assets are appreciated by this process, its productive capacity is markedly eroded. In other words, a company's ability to generate real earnings is divorced from the appreciation of its financial assets. With its asset prices rising and its productive profitability declining, it is clear that a financialised firm's growth is based on a speculative sharemarket, one that is out of touch with the prevailing conditions of the real economy. In the aggregate, with most companies following this financialised model, this is an extremely unsustainable platform for an economy to follow. It is for this very reason that for the last thirty years the American economy has experienced an increasing number of speculative booms and busts, of which the 2008 crash is but the latest example. If the United States is ever to escape from this debilitating path, then some fundamental changes need to be made to the underlying structure of its economy.

"Shareholder Governance": An Internal Imperative

From the above analysis we can see how the imperatives of the sharemarket placed an external constraint upon the actions of corporate America. Any publicly-listed company had to either conform to the short-term requirements of the sharemarket; or be subsumed in the takeover strategy of a rival firm, whose mode of business operations was more closely in tune with that of the financialised system of economic relations. In addition to this external influence, beginning in the early 1990s, an internal imperative began to be implemented in an effort to further orient the business strategies of America's corporations in line with that of the financialised model. This internally-driven orientation was implemented under the term “shareholder governance”. By refocusing corporate objectives into generating expanded profits for its shareholders, it was argued, corporate enterprises would become more attractive outlets for investor funds, and as we have seen, it was access to these funds that was primarily behind the drive in corporate growth during this period.[171]

The means devised to internally achieve this objective was to realign the personal interests of a company’s senior management with that of the company’s short-term sharemarket performance. This was achieved by the awarding of ‘options’ to the chief executives and other members of senior management within the firm. ‘Options’ are a commitment that allows its recipients to buy shares in the company at a set price in the future, regardless of the going rate of the shares at the time of purchase. In this way, if the company’s share price has appreciated beyond the set price of the shares found in the ‘options’, its recipients are able to personally pocket the difference in this appreciation.[172]

Because senior management could now personally fortune from the financial appreciation of the company’s shares, they now had a personal stake in maintaining the short-term share price of the company on the national sharemarkets. If the company’s share price experienced spectacular returns in the short-term, so in effect, would their take-home salary. Now corporate executives had a personal incentive in implementing the cost-reduction reforms that had proved effective in improving company performance in the short-term. More and more throughout the financialised era, management ‘skill’ became merited on the ability to initiate the greatest amount of redundancies within a single firm. CEOs that personally cost thousands of ordinary Americans their jobs were lionized as heroes by the nation’s business media, and through the provision of ‘options’, were financially rewarded for the debilitating impact they were having upon the real economy of the United States.[173]

It is absolutely remarkable that such a crude method of management practice was held up as the epitome of strength within corporate America. For an insight into why this indeed became the case, it is necessary to examine the underlying ideology

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[171] Ozgur Orhangazi, ‘Financialisation and Capital Accumulation in the Non-Financial Corporate Sector: A Theoretical and Empirical Investigation on the US Economy: 1973-2000’, in *Cambridge Journal of Economics*, Vol.32, No.6, 2008, P.863

[172] Joseph Stiglitz, *The Roaring Nineties: A New History of the World’s most Prosperous Decade*, Penguin, 2003, P. 115

[173] Sam Pizzigati, *Greed and Good: Understanding and Overcoming the Inequality that Limits our Lives*, Apex Press, 2004, P.16

behind the concept of 'shareholder governance'. The concept of 'shareholder governance' came from a branch of neoliberal economics called 'agency theory'. This theory provided a formula on how to run a business organisation along market lines, in the absence of a single owner in charge of the business. In this way 'agency theory' was a neoliberal response to the twentieth century development of the planning system, where the American economic landscape changed from the 'entrepreneurial capitalism' of the nineteenth century - where companies were majority owned by a single individual - to the one where companies were largely managed by salaried employees. Ignoring the great commercial success achieved by the salaried managers of the planning system, 'agency theory' argued that this twentieth century development embodied one of the fundamental problems of American capitalism, identifying it as one of the underlying causes of what neoliberal theorists defined as the inefficient production processes of corporate America. Thus according to 'agency theory', if the 'efficiency' and 'dynamism' of American capitalism were to be restored, then top corporate management needed to operate more like owners of the organisation, similar in vein to the 'entrepreneurial owners' of the nineteenth century. And what better way was there to make management operate like owners, than to actually make them part owners, through the granting of company shares.[174]

Agency theory carried a major flaw in that it failed to differentiate between the different forms of ownership between the two systems. In contrast to the huge financial commitment involved in the forthright ownership in the physical productive properties of a company, as was undertaken by the 'entrepreneur-owners' of the nineteenth century, shares offer a much more liquid form of ownership, especially since they can be readily sold on the daily markets. Consequently, rather than reflect the financial commitment undertaken by the nineteenth century 'entrepreneur-owners', the shareholding corporate management of the 1990s began to adopt the tendencies of the 1980s corporate raiders.

Thus in direct contrast to its stated aims, the implementation of 'agency theory', rather than working to strengthen management's commitment to the business, in practice encouraged CEOs to become more like financial players, who operated the corporation as a source of collateral that enabled them to participate in the financial markets, rather than the company existing as a profitable source of production in its own right. The decade of the 1990s is flooded with examples of the trend whereby a

[174] William Lazonick, 'The US Stock Market and the Governance of Innovative Enterprise', in *Industrial and Corporate Change*, Vol.16, No.6, pp 985-986

celebrated CEO is appointed to head an already established company. On appointment, the new exec lays off a few hundred workers, sells off some productive equipment – a short-term cost-reduction that spectacularly boosts the company's outgoing share price. With his reputation riding high from this acclaimed 'success', the CEO leaves the firm to take up a position within another company, in the process leaving the original company to flounder as a result of the reductions made in its productive capacity, in terms of both crucial staff and physical assets.

In order to illustrate this debilitating development, here are a few examples provided by the journalist Sam Pizzigati of the above trend in action. According to Pizzigati, in April 1994, Al Dunlop became Scott Paper's "first CEO ever hired from outside company ranks. Just two months after arriving he [Dunlop] announced plans to slice the company's workforce by 35 percent, over 11,000 jobs".[175] In addition Pizzigati documents how, once appointed as chief executive, Dunlop "almost immediately deprioritised… expenditures that did not directly pump up Scott Paper's quarterly earnings".[176] In consequence the company's budget for research and development was cut in half.[177] However, as soon as this strategy had generated the intended effect on the company's short-term share price, Dunlop cashed in on his options and left the company, thus personally profiting from the destruction of the company's productive capabilities. As such, in:

> July 1995, just fifteen months after taking charge, Dunlop clinched the deal that would, later that year, end Scott Paper's long history as an independent enterprise. Competitor Kimberly-Clark, the Kleenex Company, would buy out Scott Paper and swallow the company whole – all except Dunlop and a handful of his executive pals, who under the terms of the merger deal, got ample severance packages.[178]

To illustrate the profitability for Scott Paper's top management in initiating the company's takeover by its primary competitor, here are a few examples of the severance deals provided to them: Richard Nikolasi, head of marketing, received "$17.2 million for his sixteen months of service in Scott Paper". Likewise, the company's chief financial officer was provided $14.9 million; Dunlop's deputy, Russell Kersh got $16.4

[175] Pizzigati, *Greed and Good*, P.52
[176] Ibid
[177] Ibid P.53
[178] Ibid

million for his troubles.[179] As for Dunlop himself, no other words can best describe his raider style of management than the words of praise sung by his own mouth: "After twenty months of intense work – and thanks in part to my own stock purchases, options and other incentives – I left Scott $100 million richer than when I arrived".[180] It was through this shameless personal enrichment strategy that Dunlop achieved celebrity status, earning the nickname "Chainsaw Al". According to one of his followers, "Al goes in like a chainsaw. He goes in and cuts away all the fat and leaves a great sculpture".[181]

Another CEO that enjoyed celebrity status alongside "Chainsaw Al" was Jack Welch, who headed General Electric during the 1990s. Under Welch's leadership, "General Electric managers ranked their professional employees every year by category, the top twenty percent, middle seventy percent or bottom ten percent".[182] Within these ranked divisions, the top strata received accolades, the bottom group got fired. "Not removing that bottom ten percent" Welch explained to the company's shareholders, "is not only a management failure but also false kindness as well".[183]

There are numerous other examples throughout the 1990s, where the productive decline of a company has served to personally enrich its senior management. According to Pizzigati's research, "Intel's top five executives exercised over three million options in the first half of 2000. These shrewd option moves gained the five executives $160 million by September, just three weeks before Intel started announcing bad news about sales".[184] In another example, the CEO of Cisco Systems "alone got $156 million by unloading options early. Together, the top half dozen executives at Cisco cashed out almost seven million options before Cisco's shares peaked late March 2000. They cleared $307.8 million in option profits".[185]

The proponents of agency theory continually credited CEOs like Welch and Dunlop for the "value creation" they brought to American enterprise.[186] The problem with this accreditation however, is that these managers created nothing, in fact they achieved the inverse, they destroyed productive capabilities. Under their style of management, staff were made to be more productive by cutting down the company's

[179] Ibid
[180] Al Dunlop cited in Ibid
[181] Ibid P.52
[182] Ibid P.72
[183] Jack Welch cited in Ibid
[184] Ibid pp 42-43
[185] Ibid P.43
[186] Ibid

workforce and making the remaining staff work more while paying them less (as evident by the stagnation of wage growth during this period).[187] No training initiatives were implemented in order to up-skill the company's workforce and achieve productivity improvements in this way. Nor were technological investments undertaken in order to improve the technological tools the workers were using in order to achieve productivity gains. No, downsizing was adopted as the principal strategy of improving productivity within the American workforce.

Downscaling was initiated on a massive scale, in the attempts of corporate America to rapidly shore up costs in order to generate short-term boosts in the price of their shares on the financial markets.[188] For the giant corporate conglomerates like General Electric, this downsizing strategy would extend to whole divisions within the company apparatus. If a division ever experienced a short-term dip in profitability and thus placed a drag on the company's overall price-earnings ratio, then the division was simply disbanded, with its assets sold off to recoup the losses made from the company's temporary slackening in growth. This sale would then boost the company' short-term revenue and thus elevate its price-earnings ratio on the financial markets.[189] Notably, no effort would be undertaken to improve the division's performance through investment initiatives in order to improve productivity, or to address the problems associated with a stressed and overworked staff, which may in fact not have had enough manpower to realise the division's full productive potential. No the division is simply stripped and sold and its productive potential destroyed. Meanwhile the strategy is described via the Orwellian notion of "value creation".

It is here where we see the massive departure from the productive enterprise of the planning system to the hollowed out shells that prevailed throughout the financialised era. The great success of the planning system in the Golden Age period rested on the collective power of the country's major corporations. Company managers organised human resources in a manner that enabled economic growth to be achieved through the progressive advancement of technology and skills. Indeed, the power of organisation within the American postwar corporation had advanced to such a scale that by the early 1990s there existed ample opportunities for predatory managers to start pulling apart and selling off productive pieces of these organisations, earning a

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[187] Damon A. Silvers, 'How a Low Wage Economy With Weak labor Laws Brought US the Mortgage Credit Crisis', in *Berkeley Journal of Employment and Labor Law*, Vol.29, No.2, 2008

[188] George Soros, *The Crisis of Global Capitalism: Open Society Endangered*, New York Public Affairs, 1998, P.129

[189] Pizzigati, *Greed and Good*, P.72

substantial personal fortune in the process. Years and years of collective commercial endeavour had been dedicated into the growing of the productive capacity of these businesses, all to be stripped bare within the short space of a few years in order to personally enrich a small minority of unskilled managers who understood nothing of the productive processes that they presided over. It was the long years of productive investment under the previous era of the planning system that had created the real value of contemporary corporations, not the crude management practices of the 1990s.

In Galbraith's analysis of the postwar planning system, we saw how the commercial power of the productive sector was maintained over that of financial interests. Control over the productive process was primarily maintained by a management who held detailed knowledge of the complexities involved in the company's advanced technological production. This was a knowledge that had been gained through long years of training and employment within the company by senior management. It was this knowledge that the rentier lacked and which thus lay key to the commercial independence of the productive sector from control by its financial backers.

However, in attempting to align the interests of senior management with the interests of the financial sharemarkets, management came to be composed not by experienced senior staff members, but by individuals who expressed all the traits of a financial rentier. Often, such as in the examples of Al Dunlop and Jack Welch, these managers were appointed on the basis of a reputation earned outside the enterprise they headed. In consequence, these men knew little of the complex production process that constituted the true form of value creation in the company. What this new breed of corporate management did know however, like the professional players on the financial markets, was how to use productive assets as a means to make spectacular gains on the short-term sharemarkets. By doing so, they sold off and dismantled corporate organisations that in many instances had taken over fifty years to develop into the productive organisations that they embodied before the speculative sharemarket movement of the 1990s.

Just like those who personally profiteered from the commercialisation of the internet during the dotcom bubble, these managers made fortunes by cashing in on the fruits of a long line of earlier investment. Despite what conventional economic theory made of the strategy, the economic history of the United States clearly illustrates how most CEOs in the 1990s were not creating value but rather destroying it, as evident in the decline of the productive capacity of corporate America during this time. Notably, the productive capacity targeted by senior management in their cost-cutting drives had taken years of dedicated work and investment by a large number of workers to achieve, all lost in a short-sighted attempt by a few individuals to inflate their own salaries.

Thus by ascribing human behaviour to the Smithian logic that society is simply composed of self-interested individuals, agency theory put at the helm of capitalism's most productive organisations, self-maximisers who personally profiteered from the rapid erosion of corporate America's productive capacity. This destruction illustrates one of the most visible ways in which the extremely narrow focus of neoliberalism is inherently inimical to the real needs of advanced capitalism.

The Structural Implications of Financial Market Dominance

According to the neoliberal consensus, free markets are the most effective mechanism for determining the accurate price for a good or service. What this ideological assertion ignores however is the significant differences that exist between different market types. In contrast to the neoliberal position that theorises one big homogenous 'market', a capitalist system is composed of a plethora of different market types. For the purposes of analysis, these different market types will be broken down here into two broad categories: financial markets and productive markets.

In a financialised economy, whenever economic analysts speak of the 'markets', they invariably refer to the financial markets, not to the consumer markets of the real economy. This is in recognition of the fact that in such an economy, commercial viability is primarily dependent on financial performance. As such, in a financialised economy, it is the financial markets that largely determine the prices of goods sold in the consumer markets. Generally speaking, the financial markets will generate pressure on producers to reduce their prices on the consumer markets. As we have seen, the threat of takeover through the sharemarket prevents the possibility of corporations undertaking any long-term productive investment projects, as this sucks up a significant sum of working capital, which short-term investors in the sharemarket identify as a drop in short-term profitability and respond by selling off their shares accordingly. Consequently, due to insufficient productive investment, competition ceases to function along the lines of innovation and quality. With competition no longer running along these lines, the only avenue for different producers to compete on is in terms of price.

Thus from the 1980s onwards we can see a real depreciation in the price of consumer products within the US market. This price depreciation – which primarily occurred in electronic and manufactured items – accounts for the corresponding low levels of inflation that were experienced during this period. As we have seen, keeping rates of inflation low has become the central concern of the Federal Reserve's monetary policy, so this process of price depreciation amongst the manufacturing sector has largely conformed to this governmental macroeconomic preoccupation. Inflation was identified by the neoclassical monetarists as embodying a disruptive mechanism that distorted prices and thus sent the wrong signals to financial investors in regards to which business or industry constituted the best choice to invest in. In this way inflation was argued to prohibit the efficient allocation of resources by the free market system.

However in over-emphasising the negative effects of inflation, the neoclassical school has largely ignored the highly destructive implications ongoing price depreciation has had on the structure of the American economy. To compete on price, a company must compete on costs. As the empirical example of the United States economy clearly demonstrates, the imperative to constantly cut costs is extremely destructive for a country's productive capacity. It was in this way that the financialised structure of the American economy existed as the direct opposite to the form of growth generation that fuelled the country's economy in the post-war planning system of the Golden Age period.

One of the most common methods of reducing manufacturing costs within corporate America since the mid 1990s has been the outsourcing of production processes to offshore locations, where labour costs are significantly lower than that inside the United States.[190] Outsourcing has had two main ways in which it has reduced labour costs for American corporations. Firstly, there is the direct reduction it has had, in that it replaced positions that once paid a middle-class salary within an advanced economy, into poorly-paid positions that operate within the sweatshops of developing nations. Secondly, outsourcing has had an indirect effect through the implicit threat it holds for the remaining workers inside America if they push for higher wages or better working conditions. Through the rise of outsourcing, American workers witnessed firsthand the repercussions that would be enacted if their cost of labour was pushed too high for the financial markets to bear. As such they have held back their activism accordingly.

[190] Robert Reich, *Supercapitalism*, New York: Alfred A. Knopf, 2007, pp 61-62

The majority of jobs that were outsourced were positioned within the once-dominant manufacturing sector.[191] Under the planning system, these jobs primarily constituted well paid middle-class positions. The prevalence of these well paid jobs provided these workers with substantial disposable income. This enabled these workers to spend within the country's consumer markets, thus generating the main source of aggregate demand that was fuelling economic growth during this period. As we have seen, the manufacturing sector was the hardest hit by the emergence of cheaper foreign competitors, who began their rapid penetration into the US market during the 1970s, a process that was later intensified during the first half of the 1980s when the price-competitiveness of foreign imports was assisted by a high exchange rate for the US dollar. In order to compete with its lower-cost competitors, American manufacturers chose to relocate large portions of their own production to lower-cost locations. The nature of the short-term sharemarkets intensified the pressure on American producers to outsource production and lower their operating costs. Daily stock trading and the publication of quarterly earnings largely prevented the possibility of initiating long-term innovative investment as a means to outcompete cheaper foreign competition on terms of innovation, or technological sophistication.

Short-term sharemarkets thus provided no other workable alternative than for American manufacturers to compete on price, and in a globalising economy, the most effective means to maintain price competitiveness is to relocate production to the cheapest location. In terms of the overall international economic structure, this trend exacerbated the demand-depressing effects the export-oriented growth strategies were having upon the global economy. Previously it had proved strategic for emerging economies to keep demand at home low, in order to maintain low production costs and a cheaper currency and thus maintain price competitiveness on the international markets. This was the strategy that had enabled West Germany and Japan to undercut the US in its own consumer markets, accounting for the rise of these economies during the 1970s. In the new international conditions that evolved throughout the 1990s however, not only did developing countries have to keep conditions of domestic demand low so as to be price competitive on the international markets, they now also had an additional incentive to keep conditions of aggregate demand at home low, so that they could offer an attractive – as in low cost - location for multinational corporations to establish production in.

[191] Ibid

In this way, the demand-depressing tendencies that were generated from the undercutting strategies of the export-oriented growth models received a further intensification in the 1990s, as the emergence of global supply chains proved a popular method of keeping corporate production costs down to a minimum. The outcome of this trend was to place further limits on the growth of global aggregate demand, as jobs that had once paid a middle class wage in a highly developed economy, were now being paid at subsistence levels in a developing country anxious to keep its labour costs low so as to continue to attract foreign direct investment. What this essentially means is that workers who could once afford to purchase the product that they are producing, are now losing jobs to workers who can barely maintain their cost of living with the wages they are paid, let alone the disposable income to purchase the product their employers are selling in the global marketplace. It is in this way that within the international economy, supply is far outstripping demand. The aggregate wages paid out in the global supply chains are no way near enough to purchase the goods manufactured by the global economy.

It is interesting to compare this development to the Keynesian concept ‘the paradox of thrift,’ which was used to partly explain the economic depression of the 1930s. This concept argues that a recession can occur when a drop in business confidence spurs both business and consumers to save more of their income and refrain from spending within the economy. This lowers the level of aggregate demand in the economy, making business conditions worse and ultimately leading to an economic downturn or recession. However from a global perspective, the deficiency in demand that exists today is not the result of excessive saving by workers as the ‘paradox of thrift’ suggests. No, it is simply due to the insufficient level of wages paid by big business in the world economy, which has led to a contraction in the consumer markets available to purchase the products sold in the international economy.

However, the severe deficiency of aggregate demand that exists at the international level has not led to an economic depression of global dimensions, similar to the one that engulfed the world economy in the 1930s. This indeed proves an interesting paradox, and the reason why this paradox exists is due to the corresponding expansion in credit that has accompanied this period. The exponential expansion in credit in the United States (and other developed nations), as a means to fill the gap in global aggregate demand that has been created by insufficient wage growth, is more than just a coincidence. Indeed the expansion of credit within the United States corresponds closely with the export-oriented strategy of other economies. In order to maintain a low valuation for their exchange rates against the US dollar, as a means of ensuring that their exports would be price competitive inside the United States' consumer markets, many trading nations have purchased a large amount of dollar-denominated assets, and hold these assets within their central banks. These purchases have sustained the international demand in the dollar, maintaining its high price compared to the currencies of other exporting nations. In turn, this flow of foreign funds into the United States has provided the country's financial sector with the growth in liquidity required to sustain its speculative expansion. It was this continual inflow of foreign funds that distorted the picture that had been assumed by conventional economic theory and gave rise to the problems we are now seeing inside the United States today.

Generally speaking, in a closed economy, a speculative boom is collapsed when the flow of funds generated by saved earnings in the productive sector reaches its limits, thus reducing the liquidity that the financially-driven speculative boom rested on for its expansion. This levelling-off of liquidity warns investors that the boom is driven more by speculation than the growth of economic fundamentals – as evident by the inability of the productive sector to generate the sums required to sustain the boom of growth on its upwards trajectory. It thus becomes apparent that the boom in financial growth is divorced from the growth of the productive economy, a realisation that cools investor activity and reverses the speculative trend of the bubble. The benefit of this system is that credit creation is largely limited to the growth prospects of the productive economy. This ensures that speculative booms, while they may occur, have very clear limits on their growth and duration, thus ensuring that the subsequent crash is not from as high a point as what otherwise would have been the case. This enables a faster turnaround from the crash and also limits the amount of productive losses caught up in the following downturn.

However from the 1980s onwards, financial investment within the United States became largely divorced from the prospects of the country's productive economy. The increasing inflow of foreign funds provided an alternative source of liquidity for the financial sector, separate from the profits generated through productive endeavours within the country's domestic economy. Foreign funds thus spurred on the process of financialisation that was rapidly engulfing the country's economy. With financial sector activity divorced from the liquidity limits of the productive economy, and with the productive economy now highly dependent on the financial sector for its growth under the short-term drive of the nation's sharemarkets, the expansion of credit within the United States' economy proceeded at an exponential rate.

Due to the declining ability of the US economy to engineer productive returns for the financial sector, an increasing array of financial instruments were invented as a means to generate financial profitability from the speculative bubble that was engulfing the economy. These financial instruments included: securitization, derivatives, options, futures, and a whole host of other financial devices, whose increasing complexity served to mask the distance the financial economy had divorced itself from real earnings generated within the productive sector.

From a medium-term perspective, the great disparity that exists between the decline of demand in the productive sector and the exponential expansion of credit-creation within the financial sector, ensured that when the economy finally did crash, its effects would be massive, reverberating throughout the global economy. It is for this reason that the credit crunch of 2008 has had such a lasting impact on the global economy. The current recession is the manifestation of thirty years where real global aggregate demand has contracted, while credit has expanded at an unsustainable fashion. If an effective sustainable long-term solution to the current crisis is to be established, then the dramatic deterioration of the real economy has to be addressed. Furthermore, the excessive reliance on credit as a stimulus to growth has to be revealed for what it is: a mask that hides the real problems of the global economy.

The next section will look at how this credit-created mask has been used to hide some very real problems inside the United States economy. The United States provides a useful example as it is here where credit-creation has been the highest and the deterioration of productive capacity the strongest. This analysis of the structural problems of the United States' domestic economy provides a good insight into a number of the processes that are affecting the global economy on a wider scale.

The Structural Factors of a Low Wage Economy: The US in the Financialised Era

As we have seen, the outsourcing of American jobs primarily occurred in the manufacturing sector. Here, cheaper imports had acted as a dampener on US producers' profitability, in the process reducing their market-share and thus placing significant pressure on US producers to decrease prices in order to compete. However the nation's service sector industries, particularly the retail sector, benefited from the influx of cheap imports into the United States, as this radically depreciated their own costs for wholesale products. In turn, the giant franchises among the retail industry - of whom Walmart remains the most successful example – were able to utilise their enormous buying power in order to buy up large amounts of cheaper imported products (which were further discounted due to the ability of the retail giants to be able to buy in bulk) and use this to undercut the smaller locally-owned (and in many instances locally-sourced) retailers, who were not able to achieve the same economies of scale as Walmart and the other retail giants. This enabled the retail giants to achieve market dominance in their respective industries.

With the employment opportunities in many areas of the United States reduced by the outsourcing of the manufacturing firms and the closure of local retailers in the face of cheaper competition by the retail giants, the bargaining position of employers such as Walmart was significantly enhanced against that of its employees. This enabled the retail giants to offer extremely regressive wages and working conditions from that which had historically been acceptable within American society.[192]

Furthermore, in their efforts to keep costs down and compete on price, retail giants now overwhelmingly import the majority of the stock they sell on their shop floors. In this way the retail giants' act as a structural barrier against the ability of American manufacturers to sell locally produced products within the American market, simply because the country's retailers will not stock American-manufactured goods due to what is considered their excessive cost.[193] As a result, the retail giants operate as a structural barrier within the American economy, preventing American manufacturers from effectively competing against foreign producers. The dominant retail giants undercut and in the process eliminated the domestic retailers who stocked American products and then dominated the market by supplying American consumers with cheaper imports. In this way the rise of the service sector contributed a great deal towards the structural decline of the country's productive economy. Retail giants generated a structural barrier within the nation's consumer markets that hindered the recovery of American manufacturers from the recession of the early 1980s. In this way, from the 1980s on, the most profitable companies within the United States were those who profiteered from undercutting American producers and reducing wages and

[192] Ibid P.54
[193] Ibid

working conditions to as much as was legally possible. Walmart itself was the highest revenue earning public corporation in the United States in 2010.[194]

The logic of growth generation in the American economy has thus been flipped on its head from the sustainable system that prevailed during the era of the planning system. Economic growth for the largest firms in the country is no longer based on expanding the degree of aggregate demand within the domestic economy, as had prevailed during the planning system. Now commercial profitability is centred on the reduction of the real conditions of domestic demand in a highly destabilising and debilitating fashion.

Of all the productive components of the financialisation process, none was affected more so than the country's greatest resource, its productive labour force. Through the process of financialisation a number of structural factors were initiated, which in the aggregate have served to establish a low wage economy within the United States of America.

In addition to the threat of outsourcing, another measure employed to keep domestic wage levels down has been the hiring of temporary contractors in the place of full-time employees. This was a trend that had its precedent in the Reagan administration's response to the striking air traffic controllers in the 1980s. These striking public sector employees were personally fired by Reagan and replaced with temporary contractors. Since this industrial dispute, contract workers have become an increasing tool for private employers to keep down their wage costs.

In their research on what they refer to as the "temporary staffing industry", the economists Jamie Peck and Nik Theodore found that:

> During the course of the last three decades, the temporary staffing industry has moved from the role of stopgap-staffing provider, supplying short-term cover for eventualities such as maternity leaves and seasonal spikes in demand, to a more systematic and continuous function, mediating between companies personnel offices and their preferred labour supply's across an increasingly array of industries and occupations.[195]

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[194] *http://www.forbes.com/lists/2010/18/global-2000-10_The-Global-2000_Sales.html*

[195] Jamie Peck and Nik Theodore, 'Flexible Recession: The Temporary Staffing Industry and Mediated Work in the United States', in *The Cambridge Journal of Economics*, Vol.31, No.2, 2007, P.171

As the above findings illustrate, contract workers now constitute a significant sector in the country's labour force, a sector that is found throughout the United States' industrial landscape. According to Peck and Theodore, "approximately two-fifths of US temps are employed in clerical or pink-collar occupations, a similar proportion work in blue-collar jobs, and the remainder occupies a wide range of mainly white-collar jobs, including a sizeable scientific and technical segment".[196]

Contract workers are almost always paid less than their full-time counterparts. Peck and Theodore found that in "seventeen of the twenty top occupations [that use contract workers] the average wage earned by the temporary workers was less than the average national wage for each occupation".[197] In addition, along with paying lower wages, hiring temporary contract workers further reduces labour costs, as it enables companies to forego paying out the benefit payments that have traditionally constituted a significant part of the take-home pay packages of American workers. In their article on the temporary staffing industry, Peck and Theodore stress that the hiring of temporary contract workers "has assumed a major role in reducing employers' exposure to obligations associated with workers' compensation and unemployment insurance".[198]

From a microeconomic perspective, the rise of the temporary staffing industry is viewed as a beneficial development, as it allowed firms to reduce their operating costs and thus boost their short-term profits. However from a *macroeconomic* perspective, the rise of this industry has removed a number of important institutional stabilisers from the economy. Traditionally, the legal obligation of having to pay out unemployment insurance to any workers made redundant, acted as a disincentive to companies to shed workers in the face of an economic downturn. Because companies had to pay out unemployment insurance to any worker that was made redundant, it made sense to keep workers on, even in the face of a business downturn, since if they were going to have to keep paying them anyway it made sense for companies to keep workers on, especially as staff retention would enable a company to quickly pick up production again, once the conditions of demand had improved and the economy had begun to recover. As a result, the disincentive to fire workers provided under the legal obligation of unemployment insurance ensured that large scale unemployment would not follow a business downturn within the US post-war economy. Unemployment insurance thus operated as a key

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[196] Ibid, P.173
[197] Ibid, P.176
[198] Ibid, P.183

economic stabiliser, preventing a recession from escalating unemployment and thus reaching levels of an economic depression.[199]

However the emergence of the temporary staffing industry provided firms with a way to avoid the paying out of unemployment insurance to a significant sector of its workforce. Because these workers were hired on a contractual basis, contract workers were not legally considered as employees of the firm. As such, the firm hiring the workers did not have any legal obligation to pay out unemployment insurance in the event of their dismissal. Hiring from the temporary staffing industry therefore provided a way for American companies to effortlessly discard a significant section of their workforce at the mere sign of a drop in profitability, at no cost at all to the company concerned. This was an ability that greatly favoured a firm's commercial prospects in the short-term financialised economic structure that had emerged in America. Thus the problem with this seemingly efficient microeconomic strategy is that when expanded to the aggregate level, with most firms following this strategy, what occurs is a rapid increase in unemployment, which serves to dramatically depress the prevailing conditions of domestic demand, thus multiplying the severity of the economic downturn. Consequently, as the temporary staffing industry has grown as a proportion of the American labour force, so too has the severity of the subsequent recessions.[200]

The recovery to the 2001 recession, like the recovery following the recession of 1989-1990 before it, is referred to by economists as a "jobless recovery". This is in recognition of the inability of the American economy to generate substantial employment in the recovery phase of the economic cycle, as historically occurs in the capitalist system.[201] Peck and Theodore found that in both "recent recoveries" (from the recessions of 1990 and 2001) "aggregate employment continued to fall for more than a year into the rebound".[202] What is important to note here, in analysing the institutional foundations that held down wage growth within the US economy, was the *type* of employment that expanded when employment figures began to finally increase. According to Peck and Theodore, between "March 1991 (the end of the recession) and March 1992 the economy had lost a net 24,000 jobs, despite an increase of 131,000 temporary workers during the period".[203] Clearly therefore, as the economy began to

[199] Ibid, P.186
[200] Ibid
[201] Robert Reich, 'The Great Disconnect Between Stocks and Jobs' Nov 18 2009 on www.robertreich.org/post/257310728/the-gt-
[202] Peck and Theodore, 'Flexible Recession', P.178
[203] Ibid

recover, business enterprises were looking at replacing the full-time workers let go during the recession with temporary contract workers, who were able to be quickly dismissed in the event of another downturn. Thus as the commercial orientation of American firms became more dependent upon sharemarket performance, employment decisions became more centred on the need to maintain the "flexibility' of the firm's labour force. What this means is that due to the short-term demands of the sharemarket, firms needed to be able to shed workers quickly, in order to free up funds to boost share prices, in response to a short-term dip in a company' share price performance. The temporary staffing industry therefore, has largely arisen to fulfil this market function.

As a result, Peck and Theodore show that in "the wake of the recession of the early 1990s, the temporary staffing industry… experienced double-digit rates of annual growth".[204] During the financialised years of the 1990s, the temporary staffing industry cemented its place as a solid institutional actor inside the American economy, demonstrated by the fact that "[t]emp employment growth was sustained at a high rate throughout the long boom of the 1990s, establishing a market worth almost $64 billion per year by the decade's end".[205]

The institutionalisation of the temporary staffing industry is of even greater importance when analysed alongside the corresponding decline in the size and influence of the trade union movement. As we have seen, the power of the trade union movement dramatically deteriorated within the hostile political-economy of the 1980s. This is in large contrast to the position of trade unions within the post-war planning system, where organised labour embodied an important institutional actor inside America's economic structure. Periodic industrial bargaining rounds ensured that wage increases were adopted industry-wide by all firms, thus preventing the ability of any one firm to undercut its competitors on a price that was generated through cheaper labour costs than its industrial competitors. National bargaining rounds thus enabled all firms within a given industry to coordinate wage rises, and in this way firms were able to pass on the costs of these wage rises to their consumers, who in turn were more able to afford these small price rises due to the significant increase in income associated with the rise in wages. Ongoing wage rises thus enabled the country's consumer market to grow alongside the economic growth of America's productive firms, accounting for the sustained growth of the US economy during this period.

[204] Ibid, P.174
[205] Ibid

However in the financialised economy that exists today, the temporary staffing industry performs the inverse institutional function of that of the national trade unions in the planning system. In their research into the temporary staffing industry, Peck and Theodore found that "within the US temp market, large, national contracts became increasingly commonplace, as publicly traded staffing firms brokered multiyear partnerships with their major corporate clients".[206] With labour composing the sole source of competitiveness for these temping firms, entry barriers into the industry were very low. Low entry barriers enabled the establishment of new agencies, who were then able to come in and outcompete the established firms, by offering cheaper labour than the prevailing market price. According to Peck and Theodore, the temporary staffing industry "has few barriers to entry, and although there have been several waves of consolidation, the US market remains highly fragmented".[207] In consequence, the "arrival of thousands of new temporary staffing agencies further saturated the high-volume of pink-collar and blue-collar segments of the market, where entry barriers are lowest".[208] As a result, Peck and Theodore describe the industry as one where staffing:

> Agencies effectively replicated a 'low road' business model, providing limited value added services, holding down billing rates and pursuing high volume accounts. A mode of 'destructive growth' was established, as industry stalwarts and start-ups were thrown into competition in maturing markets characterised by intense, price-based competition. Aggressive pricing strategies on the part of large firms, coupled with endemic undercutting among small agencies, contributed to falling gross margins across the industry, even as national unemployment rates plunged and worksite employers struggled to cope with worker shortages.[209]

Thus with the growth of the temporary staffing industry (TSI), we have the development of an institutional structure that works to suppress wage growth within the American economy. Under temping agencies, workers are represented by an organisation whose aim is to keep their wages down as low as possible, in order to remain price competitive in an industry that is purely centred on labour rather than technological competitiveness. Thus while trade unions organised labour in an effort to increase workers' income; TSI organises labour in a way that reduces it.

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[206] Ibid,
[207] Ibid, P.186
[208] Ibid
[209] Ibid

Indeed the intense competition inside the TSI industry prevented contract workers from increasing their annual income, even in the tight labour market conditions that developed during the second half of the 1990s. In theory, according to neoclassical economics, a tight labour market should enhance the bargaining power of individual workers, enabling them to negotiate higher wages and better working conditions. However the prevalence of the temporary staffing industry represented a structural barrier that suppressed this theoretical labour market function from coming into fruition. Even though in terms of numbers, each individual worker was in short supply in the United States during the mid-1990s and thus in theory had the bargaining power to negotiate higher wages with their employers, contract workers were represented in the workplace by the TSI firm, who due to the large supply of temping agencies in operation, faced competitive pressure to lower the price of their labour. Workers within the temporary staffing industry thus experienced significant pressure to reduce their real wages, and it was this pressure that undermined the individual bargaining position afforded to them by the tight labour market conditions of supply. By extension, the sheer number of contract workers within the American workplace put pressure on paid employees to accept the low wages and regressive working conditions found within their respective industries. The highly visible threat of being replaced by contract workers if adversarial actions were undertaken by employees in an effort to improve their working conditions, were enough to keep wages low and regressive workplace policies in check. The prevalence of the TSI industry thus acted as a very strong disincentive for labour to adopt a hardline measure against the regressive wages and working conditions of the period.

By the 2001 economic recovery, Peck and Theodore argue that this “new dynamic between temporary employment and the wider labour market seems to have become entrenched”. The authors demonstrate this fact by showing that after “[t]wenty-four months into the recovery, the economy continued to shed jobs at an historically high rate (-624,000), yet robust growth in temporary employment (+241,000) had been underway for some time. Only after thirty months of recovery [did] the economy finally began steadily to add jobs overall, with the temporary staffing industry continuing to play a leading role”.[210]

The trend embodied in the temporary staffing industry is part of a wider trend that aimed to commodify labour into ‘flexible labour markets’. This had a profound

[210] Ibid, P.178

effect on the quality of working conditions and the level of wages found throughout the American economy. According to neoclassical economic theory, 'flexible labour markets' - or the ability to be able to easily fire workers - was an effective mechanism that enabled workers to be removed from inefficient sectors of the American economy, freeing them up to be re-employed in other more efficient and profitable sectors where their labour would be better utilised. This economic theory fitted in with the short-term sharemarket priorities of the country's financialised corporations. As we have seen, in large corporate conglomerates like General Electric, the financial prioritisation of maintaining a high share price often dictated the need to sell off a division of the firm, or to readily dismiss a large number of workers, in order to rapidly reduce company costs and thus boost short-term profits.

However neoliberal economic theory, with its emphasis upon the microeconomic level of the individual firm, failed to take into account the macroeconomic effects the precarious nature of employment was having upon the American economy. In his research into working conditions inside the American economy, the journalist Peter Gosselin found that due to need of having to move in and out of different jobs – as stable employment gave way to flexible labour markets – over time workers accepted lower and lower wages, as their own financial situation became more desperate after each successive redundancy. Gosselin found that, with the exception of "workers who find themselves in hot sectors of the job market, those who must change jobs frequently often have trouble maintaining their income levels. Benefits such as health insurance are interrupted or even lost, especially in an economy that now relies on smaller companies to create many of its new jobs".[211] Gosselin cites a study that "looked at people who lost full time jobs between 2001 and 2003 but were fortunate enough to find full time replacement positions, and so were comparative winners in the job loss process". The results from the study found that these "re-employed people made, on average, seventeen percent less than they would have had they managed to hang on to their original position". According to Gosselin, this income drop was "double the wage loss of the late 1990s". Gosselin argues that "since annual rises are fairly modest in most job categories these days, it is difficult to impossible for those who lose jobs to catch up after they go back to work".[212]

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[211] Peter Gosselin, *High Wire: The Precarious Financial Lives of American* Families, Basic Books 2008, P.115
[212] Ibid, P.26

Through further research into the causes behind the economy-wide stagnation of American wages, Gosselin found that "on average, college graduates who lost their jobs in the early 2000's ended up with wages in their subsequent jobs that were more than twenty percent lower than what they would have made had they held on to their original position".[213] As these findings make clear, the debilitating impact the financialisation of the American economy is having upon employment is spreading up the labour chain. Originally, the neoliberal justification for the downsizing and wage stagnation underway in the US economy was that it was only the low-skilled and unproductive sectors that were being targeted by this process. Their eventual disappearance from the US economy, it was argued, would act as an incentive for workers to up-skill and move into more 'knowledge-intensive' industries.[214] However as the above statistics illustrate, employment in 'knowledge intensive' industries – defined here as industries that require a college degree to enter – are now subject to the same income-reducing measures that previously wrecked havoc among the blue-collar sectors of employment. Clearly therefore, the implementation of supply-side policies has not worked to institute greater efficiency measures within the productive sector, rather it has operated to divert more and more capital out of the productive sector and into the pockets of financial investors. As a result, there has been the increased spread of employment volatility and income inequality right up the production chain.

The extension of employment volatility and income reducing trends into occupations requiring a college education has had an enormous influence upon the types of professions American students are now adopting as their chosen career. Daniel Brook, a young American journalist, found that due to the widening income disparities between different professions within the US economy, the students of his generation faced a number of structural pressures directing them towards a particular type of occupation, namely within the financial sector. Brook argues that "talented young people actually have less control over their lives in a society in which they can get rich quick because, in such a society, the consequences of not getting rich quick become much more serious".[215] This paradox was due to the fact that the inflated earnings of finance professionals and others whose on-paper wealth experienced exponential growth during the financialised period, greatly appreciated the price of rents in the

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[213] Ibid, P.27

[214] Pablo Beramendi and Thomas R. Cusack, 'Diverse Disparities: The Politics and Economics of Wage, Market and Disposable Income Inequalities', in *Political Research Quarterly*, Vol.62, No.2, June 2009, P.264

[215] Daniel Brook, *The Trap: Selling out to Stay Afloat in Winner Take All America*, New York: Times Books, 2007 P.10

country's main urban centres. According to the scholar Niall Ferguson, in "recent years, the pay packages in finance have been nearly three times the salaries earned by Ivy League graduates in other sectors of the economy".[216]

The increase in urban rents rendered a large number of professions unaffordable occupations for young Americans to consider. Brook provides the example of Jason Eckel, a twenty-six year old music teacher. According to Eckel, if he had stayed living in the same city where his job is, he "would have kept going slowly broke from renting". Eckel argues that it was only "because I was a single guy living in a not-so-nice apartment I was surviving. I was paying a $1200 rent for a one-bedroom apartment". For Eckel, this rent "was over half my salary".[217]

In addition the dramatic increase in college tuition fees, and the corresponding rise in student debt that this has provoked, further intensified the pressure felt by young Americans to direct their education towards a career in the more affable financial sector. In recognition of this structural pressure, Brook argues that "as the return on education investment increases if one pursues finance or a handful of other corporate fields, so too does the penalty for anyone who wishes to pursue another path".[218] To illustrate his point, Brook provides the scenario of an "idealistic University of Chicago graduate from the class of 1980 who opted to stay on the south side and teach in an inner city public school". According to Brooks, in 1980, such an individual "would have earned $13,770, more than two and a half times her $5,100 senior year tuition. Today such a student would earn $38,551, only twenty-three percent more than her senior tuition of $31,500".[219]

In this way, student debt acts as a disincentive to embark on a career of public service, or indeed any other career that is not located within the financial sector, as the costs involved in such a career prove too great for many well-educated Americans to consider. This discourages talented Americans from taking up occupations that have socially important functions. One of the outcomes of this is that the quality of public schooling in many urban centres is deteriorating. In turn this increases the attractiveness

[216] Niall Ferguson, *The Ascent of Money: A Financial History of the World*, Penguin Group Australia, 2008, P.5
[217] Jason Eckel cited in Brook, *The Trap*, P.29
[218] Ibid, P.35
[219] Ibid

of the top schools – along with the rents in the top school zones – thus exacerbating the problem of affordability in undertaking a career outside the financial sector.[220]

While indeed there may exist a number of selfless young Americans who still engage in socially important occupations, this work is really only sustainable while they are still young and single. Later on, when they are at the peak of their productive lives, family commitments will require many of these individuals to abandon this socially important employment and engage their energies towards the generation of wealth for financial shareholders within one of the nation's financialised firms.[221] According to another interviewee of Brook's, a man who called himself Rajiv, based in Marin County California, "wherever the school district is good, the housing prices are very high".[222] High rents in the zones of the top schools increases the pressure put on many Americans to take up an occupation within the financial sector, once family commitments become a top priority in their lives. An example of this is provided by Valerie Orth, a staff member at the not-for-profit organisation Global Exchange. Due to the great disparity that exists between the pay at Global Exchange and the rents in the surrounding area, Valerie claims that: "Once I have kids, I don't think any of this is sustainable. I don't know how anyone at Global Exchange has kids". [223]

In this way, the financialisation of the US economy is generating significant social costs for the nation as a whole; social costs whose net effects will only be exacerbated into the future unless concrete action is taken now to address the macroeconomic cause of this debilitating predicament. As Daniel Brook clearly illustrates, if "they [the new generation of American workers] pursue a middle-income job, becoming a social worker or a city councilman, they know their children's lives will be hemmed in by debt. If they want their kids to get a full ride, they will have to provide it themselves".[224] It is this stone-cold fact that has decimated the strength of socially important occupations within American society, increasing the pulling power of the dominant financial sector in the process.

[220] Ibid, P.44
[221] Ibid, P.206
[222] Rajiv cited in Ibid, pp 28-29
[223] Valerie Orth cited in Ibid, P. 49
[224] Ibid, P.37

Conclusion

In conclusion, the financialisation of the American economy has been a highly regressive development for the great majority of American citizens. It embodies a destabilising system that has reduced the real earnings of most American workers during this period. The neo-classical school of economic thought argues that if left unchecked, the free market will provide the most efficient and productive allocation of economic resources. However it is clear from the above analysis that in reality, the prevalence of a number of structural factors within the American economy has encouraged the free market to develop a low-wage economic system, one that has proved extremely detrimental to both the country's productive capacity along with its prevailing level of aggregate demand.

The process of financialisation represents the end-result of the practical implementation of supply-side policies. By over-focusing on the competitive conditions of supply and ignoring the inadequate conditions of aggregate demand – in both the United States and the world economy at large – the practical implementation of 'trickle-down' economics encouraged the development of an economic system that drained resources away from the productive sector in order to fuel financial speculation at the top. It was in this way that the process of financialisation embodied the ultimate outcome of supply-side policies put into practice.

It is here where we come to the nexus of the issues involved with the simple re-tinkering of the neoliberal position by contemporary policy-makers. At the beginning of the 1980s, as indeed is still the case today, the root cause of the economic problems afflicting the American economy was the insufficient degree of aggregate demand that existed at the global level. However this underlying root cause was ignored by succeeding economic policy-makers, who chose instead to concentrate on superficial symptoms that existed on the supply-side, in an aim to engineer greater 'efficiency' measures throughout the American economy. The greater the efficiency savings made however, the greater the drop in aggregate demand. It was in this way that the application of neo-liberal policies during the 1980s aggravated the very real macroeconomic problems that were present at that time.

Thus the initiation of supply-side policies from the 1980s on has merely worked to paper over the real problems of the American economy. This neglect of the underlying issues has dramatically exacerbated these problems for the United States, culminating in the severe recession that currently afflicts its economy. As such, if an effective recovery is to be implemented, the proven inability of neoliberal policies to effectively address the root cause of insufficient global aggregate demand must be acknowledged by the policy-making community. For this to occur, the economic debate must be expanded to include alternative policy positions, ones that will prove more appropriate to a macroeconomic analysis on aggregate conditions of demand. The microeconomic focus of neoliberalism has proved an inadequate paradigm for such an analysis, and new positions must therefore be promoted in order to rectify this extremely narrow analytical situation.

Chapter 4: The Build-Up to the Crash

Introduction

The conventional policy position holds that the current recession is the direct outcome of the massive expansion in credit and credit-related instruments during the years immediately preceding the crash. This paper agrees with the conventional assertion, in so far as the most immediate cause of the recession was the bursting of the speculative credit bubble that blew up during the decade of the 2000's. However, this paper aims to extend the conventional analysis by examining the reasons why credit and the trading of credit instruments were relied upon to such a disproportionate extent to fuel economic growth in the United States during this period. In the previous chapter, the paper looked at the decline in the demand functions of wage growth and long-term productive investment projects during the 1980s and 1990s. This chapter will examine the expansion of credit into the twenty-first century and show how this expansion was used to cover up the gap in aggregate demand that had been opened up by the decline of these important demand functions. This extension of the analysis is essential if the root cause of the current recession is to be effectively targeted by contemporary policy-makers.

The move away from innovative-inducing productive investment projects, together with the erosion of real wage earnings throughout the process of financialisation, worked to radically reduce the level of real aggregate demand found inside the United States' economy. Nevertheless despite this real reduction, aggregate demand was able to be sustained by the substantial expansion in credit during this period. This expansion was further increased into the 2000's, when the financial sector itself was elevated into the position of prime importance within the United States' economy, following the crash of the corporate sharemarkets in 2000 and the subsequent speculative rise of the housing market into the following decade.

This chapter will begin by examining the means in which the financial sector was enlarged and its trading activities expanded throughout the sharemarket boom of the 1990s. This discussion will include sections centred on the rise of 401(k) accounts and institutional investors; the role of credit derivatives; and the process of securitization, in expanding the size of the financial sector during this decade.

Following on from this discussion, the chapter will detail the rise of the financial sector into the position of prime importance within the US economy during the 2000's. This elevation was largely facilitated by the government-directed recovery from the recession of 2001-2002. Here the recovery was directed through a series of short-term interest rate reductions by the Federal Reserve, who aimed to reduce the cost of credit inside the US economy, particularly that for mortgage finance, as a means to stimulate economic activity inside the country.

The increase in mortgage originations that this strategy inspired, created a growing loan source that the country's investment banks –via the process of securitization –converted into a new type of financial asset. Financial trading was then able to be reoriented upon this new asset class in order to compensate for the decline in corporate equity trading following the sharemarket crash of 2000. The chapter will thus analyse the rise of mortgage-backed securities (MBS) and the interrelated collateralised debt obligations (CDOs) in order to illustrate the means in which the financial sector was enabled to continue to expand via the redirection in financial trading towards the rising residential property market. It was in this way, the chapter argues, that the financial sector was able to finally sever its link to the productive sector and achieve spectacular growth, despite the now highly visible stagnation of the country's productive economy.

Next the chapter will examine the international dimensions of credit expansion within the United States economy. The chapter argues that despite the decline of productive-based earnings during this period, the US financial sector was able to continue to grow through an increase in foreign-sourced funds into the sector, as export-oriented economies aimed to appreciate the valuation of the US dollar in order to maintain the price-competitiveness of their products inside the US consumer markets. The chapter will argue that this foreign-financed credit expansion was ultimately unsustainable and was one of the major contributing factors behind the severe credit crash of 2008. As we will see, this credit expansion merely worked to intensify the process of financialisation inside the United States, thus exacerbating the decline of the country's productive economy, which incidentally, was the only economic sector where real material earnings could be generated to reduce the country's disproportionate dependence on foreign debt as the main source of economic growth.

The combination of stagnating wages and declining employment prospects inside the country's real economy, together with the credit expansion of more and more mortgage finance to lower income households, meant that a significant proportion of debt within the American economy became progressively unaffordable for its holders. It was this combination that culminated in the collapse of the subprime mortgage sector in late 2007. The chapter will detail the build-up to this crash, illustrating how at the peak of the boom, the major Wall Street investment banks had become extremely vulnerable to a crash in the subprime sector through the activities of their subsidiary financial 'conduits' and 'structured investment vehicles'. It was the implication of these major banks in the collapse of the subprime mortgage sector that led to the severe contraction of bank lending from late 2007 on. It was this credit crunch, the chapter concludes, that led to the severe global recession of 2008.

The Rise of Institutional Investment

The prioritisation of short-term share market performance by American corporations both encouraged - and was itself an outcome - of the exponential expansion of the country's financial sector during this period. Importantly, this expansion entailed a number of highly significant developments, which taken together, transformed the nature of the country's financial markets during the 1990s. A primary influence on the changes underway in the financial sector during this period was the rise of the 401(k) account and the subsequent switch in pension plans from defined benefits to defined contributions. Roger Lowenstein, a financial scholar who documented these changes, states that as "the nomenclature suggests, 401(k)'s owe their success to an administrative accident". This accident came in a 1980 amendment instituted by Congress, whereby a short paragraph –"k"- was added to section 401 of the Internal Revenue code. "Essentially, it said that taxes could be deferred on profit-sharing plans that were open to lower-paid employees as well as executives". According to Lowenstein, "Congress's intent was modest – it was tweaking the rules that applied to existing plans, which typically applied to year-end bonuses".[225]

Nevertheless, the slight change embodied in the "k" provided US firms with another means of reducing labour costs in order to boost their short-term profitability projections. Instead of providing their employees with a guaranteed pension salary,

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[225] Roger Lowenstein, *Origins of the Crash: The Great Bubble and its Undoing*, New York, Penguin Press: 2004, P.24

based on their wages and the number of years the employee had been in service to the company, as stipulated under a defined benefit pension plan; a defined contribution plan provides each worker with an Individual Retirement account, or 401(k) account, which the company contributes funds to and through which the workers can use to invest in the financial markets, as a means to appreciate their retirement earnings.[226]

While the company is legally obliged to make contributions to its workers 401(k) accounts, it is not responsible for the performance of these accounts on the financial markets. Thus the company is not legally obliged to cover any of the losses of these accounts if they fail to generate sufficient earnings to provide for their workers' retirement. The extent of the savings generated by American companies from this switch in pension plans is illustrated by the fact that in "1980, 50 percent of the private sector workforce was covered by a defined benefit pension plan, with typical employer contributions of around 8 percent of payroll. Today, less than 20 percent of the private sector workforce has such a plan. The other 30 percent has a 401(k) or other savings account, with employer contributions averaging less than 3 percent".[227]

The emergence of the 401(k) account thus enabled American companies to abrogate themselves from the prior responsibility of providing an adequate pension for their workers' retirement. Previously this had constituted a guaranteed provision, and was an essential component of the unique welfare-state system that had developed in the United States during the postwar period. Being divested of this responsibility therefore effectively eliminated a very large liability on the balance-sheet of most US corporations, thus improving their price-earnings ratio on the nation's stockmarkets. In turn, the new 401(k) accounts provided the sharemarkets a significant boost in capital, contributing considerably to the speculative-driven process of share-price appreciation that had come to embody the primary source of profitability for America's increasingly financialised corporate sector. Thus by "1990, close to $400 billion was invested in 401(k)s. By 1995, the total had doubled".[228]

The rise of 401(k) accounts encouraged a transformation away from the established trend of long-term lending towards a new form of short-term highly leveraged borrowing amongst many levels of the country's financial sector. 401(k)

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[226] Peter Gosselin, *High Wire: The Precarious Financial Lives of American Families*, US: Basic Books, 2008, P.257

[227]Damon A. Silvers, 'How a Low wage Economy with Weak Labor Laws Brought us the Mortgage Credit Crisis', in *Berkeley Journal of Employment and Labor Law*, Vol.29, No.2, 2008, PP 463-464

[228] Lowenstein, *Origins of the Crash*, P.25

accounts were mainly managed by mutual funds. The massive influx of working capital provided by the 401(k) accounts to these institutional investors dramatically increased their role and influence within the nation's sharemarkets. According to the financial analyst Henry Kaufman, who worked on Wall St during this period, "Mutual funds role has been especially pivotal in the stock market, which was long dominated by private and public pension funds. But as private pension funds have increasingly shifted from defined benefits to defined contributions – thereby encouraging beneficiaries to select their own portfolio risk profiles – mutual funds have attracted billions of dollars of pension fund assets".[229]

James Crotly, one of the leading authors of the financialisation literature, has documented the rise of institutional investors in the stockmarkets. "Throughout the 1950's", Crotly found, "households owned about ninety percent of corporate stock and [as we have seen] tended to hold their stocks for long periods. However by "2000, households held forty-two percent". This decline was due to the fact that "institutions had become the dominant stockholders of large US corporations and were responsible for about three-quarters of all stock trades". [230]

The impact of institutional investors intensified the process of financialisation during the 1990s. According to Crotly, "Institutional investment is a highly competitive business in which a very large number of firms fight for contracts to manage very large portfolios". Due to this intense industrial competition, "[f]ailure to achieve at least industry-average rates of return for even a few quarters can lead to the cancellation of these contracts". This has in turn led to the situation where on "average, stocks are now held for just one year". As such "[r]ational stockholders … have no reason to be concerned about the performance of the companies they 'own' beyond a one-year horizon".[231] The rise of institutional investors as dominant traders in the sharemarkets thus intensified the external pressures placed on corporate management to focus on short-term sharemarket performance.

Institutional investors are also a force that served to exacerbate and expand sharemarket movements. Crotly describes the new sharemarket trading environment as a "situation ideally designed to generate herd behaviour among investors". He argues

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[229] Henry Kaufman, *On Money and Markets: A Wall Street Memoir*, New York: Mcgraw Hill, 2000, P.62
[230] James Crotly, 'The Neoliberal Paradox: The Impact of Destructive Product Market Competition and 'Modern' Financial Markets on Non-Financial Corporate Performance in the Neoliberal Era'. In Gerald A. Epstein (ed), *Financialization and the World Economy*, Northampton: Edward Elgar Publishing, 2005, Pp 91-92
[231] Ibid, P.92

that institutional investors "must follow the crowd as it rushes in or out of industries or firms or geographical areas, thereby raising and lowering stock prices". The alternative to not following this herd-like strategy for mutual funds is "to risk below-average returns, which can quickly put you out of business".[232] The scholar Robert W. Parentau also observed this herding behaviour. According to Parentau, the

> pattern that can be observed over time in the institutional investment business is as follows: investment time horizons collapsed, investment performance became defined relative to a benchmark or index portfolio, asset allocation and market timing skills were made obsolete by a monomaniacal focus on stock selection and risk became defined solely in relation to departures made from benchmark weightings. Each of these consultant inspired moves had the unintended consequence of enhancing herding dynamics among institutional investors.[233]

With this herd-like mentality in mind, it is clear to see why the information-technology (IT) sector saw such an appreciation in the price of its shares during the second half of the 1990s, and also why, industry-wide, shares in IT companies plunged so quickly at the end of the decade. Crotly found that as "institutions became more important in the market, annual stock over (the ratio of the value of the stock sales to the market value of stocks) grew ever higher".[234] Institutional investors thus increased the amount of turnover of stock sales, which in turn served to accelerate the speculative process of share-price appreciation. In the end however, all this managed to achieve for the IT sector, was to exacerbate the height and speed of the corresponding crash.

Because these institutional investors were primarily in charge of funds required for their clients' retirement, they had a prerogative to minimize their investment risk to as much as possible. Partly this risk-management involved diversifying their investments throughout a number of different financial instruments such as stocks, bonds, currencies etc. Mutual funds thus held a portfolio of investments, which ensured that if one investment dropped, that loss would only constitute a small component of the overall pool of investment funds, and would furthermore, likely to be balanced by a rise in the value of another investment asset held in the portfolio.

In addition to this portfolio risk management system, financial devices came to be designed with the intention of further reducing the amount of risk for these

[232] Ibid
[233] Robert W. Parentau, 'The Late Nineties US Bubble: Financialization in the Extreme' in Epstein *Financialization and the World Economy*, P.125
[234] Crotly, 'The Neoliberal Paradox', P.92

institutional investment funds. These financial devices primarily came in the form of credit derivatives. According to Kaufman, as "professionally managed portfolios have increased in size and scope internationally, many investment managers have sought to limit exposure to market risks by making use of derivatives. That, in turn, has been a steady source of business for financial institutions that specialize in providing financial derivatives as instruments for risk management".[235]

Credit Derivatives

A derivative is a financial instrument whose value is derived from a pre-existing financial asset. The market that exists for financial derivatives is a secondary market, built on top of the original market for the underlying financial asset. Derivatives come in a variety of forms; this includes futures, forwards, options, swaps and 'swaptions'. The use of credit derivatives has rapidly increased the amount of trading that is based on each underlying asset within the financial markets. Increased trading in the secondary derivatives market works to bid up the price of the derivative, and by extension, the price of the underlying financial asset. Derivatives have thus radically expanded the amount of credit created by a single asset within the financial sector. This credit-creation has proceeded at an exponential pace. According to the scholar Kevin Phillips, derivatives "were a relatively rudimentary market in the 1980s. Their notional value by the end of 2005, however, was three times higher than the total of all financial instruments and more than ten times higher than total global GDP".[236]

The market need to create credit derivatives in order to minimise risk, led to the emergence of a number of new institutional players within the financial sector. Because mutual fund investors needed to reduce the amount of risk contained in their financial dealings, a market need opened up for the creation of institutional speculators who were willing to take on this unwanted risk. According to Kaufman, the "fact is, for every cautious portfolio manager hoping to use financial derivatives to limit risk, there must be a willing risk taker on the other side. Without the active participation of prominent speculators, the market would be lopsided, which would make the cost of derivatives

[235] Kaufman, *On Money and Markets*, P.69
[236] Charles R. Morris, *The Two Trillion Dollar Meltdown: Easy Money, High Rollers and the Great Credit Crash*, New York: Public Affairs, 2008, P.141

prohibitive for risk-averse businesses as well as for investors who are trying to hedge open exposures".[237] This market need was ultimately assumed by the hedge funds.

While the principal proponents of credit derivatives argued that these financial devices provided a measure of stability for the financial markets, a number of more sceptical scholars argued otherwise. The scholar Randall Dodd for instance, argued that the "first danger posed by derivatives comes from the leverage they provide to both hedgers and speculators". This increased leverage is obtained by the fact that derivative "transactions allow investors to take a large price position in the market while committing only a small amount of capital". Therefore instead of taking out a large price position on a financial asset, an investor can purchase a derivative whose price is based on the entire value of the underlying asset, and through this derivative, capture returns that are derived from the full value of the underlying asset, rather than just a proportion of it.[238] For example:

> Instead of buying one million dollars of Treasury bonds or one million dollars of stock, an investor can buy futures contracts on one million dollars of the bonds or stocks with only a few thousand dollars of capital committed as margin. The returns from holding the stocks or bonds will be the same as holding the futures on the stocks or bonds. This allows investors to earn a much higher rate of return on their capital by taking on a much larger amount of risk.[239]

It is this ability, provided by the use of derivatives, which Dodd argued enabled investors to radically increase their leverage in an underlying asset. While this increased leverage does render it easier for hedgers to hedge against risk, it also conversely, "makes speculation cheaper".[240] As such, derivatives both expand the possibilities for speculation on an underlying financial asset, while also rendering the ability to engage in this increased speculation easier to undertake.

Nevertheless the majority of financial analysts continued to maintain that the use of derivatives removed a large amount of risk from the financial markets. According to Kaufman, those analysts who "believe that derivatives may decrease the volatility of interest rates, exchange rates, and equity prices generally rely on the concept of "stabilizing speculation". According to this conceptual position, since the speculation

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[237] Kaufman, *On Money and Markets*, P.69
[238] Randall Dodd, 'Derivatives Markets: Sources of Vulnerability in US Financial Markets' in Epstein *Financialization and the World Economy*, P.155
[239] Ibid, PP 155-156
[240] Ibid, P.156

undertaken by the hedge funds is balanced by the risk-averse actions of the mutual fund investors, "speculation is generally stabilizing" as risk is now borne by those most able to bear it. This therefore enables risky investments to be continued to be pursued – in the process maintaining the desirable dynamism of the capitalist system - in a manner that is not disruptive to the entire financial system as a whole. Thus by this logic, the easier it is for hedge funds to assume greater portions of risk, the more stable it is for the overall financial system. Therefore "if speculation is generally stabilizing, then volatility should gradually diminish with the proliferation of financial derivatives".[241]

In contrast, Kaufman, who "belong[s] to the opposing camp", argues that certain types of "derivatives have irreversibly changed the behaviour of the underlying financial markets on which they are based". These derivatives include "the various futures markets (and their associated options markets) on equity indexes and government bonds". According to Kaufman these "derivatives have introduced greater symmetry in position taking".[242] What this means is that trading in these derivatives has made it just as simple for an investor to go short on an underlying asset than it is to go long.[243] In this way the derivative markets enabled investors' much greater ease in changing their position on a financial asset. This therefore accelerated market movements, leading to less financial stability, not more.

From a macroeconomic perspective, the increased volatility in the financial markets introduced by credit derivatives intensified the external pressure placed on US corporations to prioritise short-term sharemarket performance. Because this short-term focus was undermining the long-term productive capacity of these firms, it is clear that the increasing use of derivatives was not managing to reduce risk, but in fact was undermining the productive basis of the real economy, whose growth had historically determined the sustainability and stability of the country's economic system.

Thus the greater volatility that the use of derivatives has brought to the financial markets exacerbates market swings and as such, works to increase systemic risk within

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[241] Kaufman, *On Money and Markets*, P.77

[242] Ibid

[243] Short-selling is the practice of selling an asset that is expected to decrease in price in the future. Here the investor hopes to profit from a decline in the price of the asset between the sale of the asset and its subsequent repurchase, as the investor will pay less to buy back the asset than the seller received on the original purchase. The difference between the price sold and the price repurchased constitutes the profit of the investment. In contrast, going long is the traditional investment strategy where an asset is expected to appreciate into the future

the economy. According to Kaufman, derivatives work to "amplify the business cycle by introducing more leverage into the system and thus expand credit availability, especially for marginal borrowers".[244] Dodd supports this assertion, he argues that the "spreading of the losses and failures" is symptomatic of the condition "systemic risk". Dodd defines this as an "economy-wide problem that is made worse by leverage and leveraging instruments such as derivatives".[245]

Securitization

Along with derivatives, another financial device that served to increase liquidity and the expansion of credit-creation within the country's financial sector was the process of securitization. The scholar Karl Beitel defines securitization as the "process of transforming formerly illiquid loans held in the banks' own portfolios into marketable (negotiable) assets traded on secondary bond markets".[246] Through securitization, loans that were previously considered to constitute both a liability (in the case of default) and an asset (by being repaid) were packaged up and sold to outside investors and thus transferred to pure assets for the investment bank selling these loans on to the secondary securities market. The process of securitization was argued to distribute and disburse the amount of risk carried in each loan among a wider pool of investors, thus contributing to greater stability within the overall financial system.

As securitization involved the conversion of formerly non-marketable instruments into marketable assets, the process greatly expanded the amount of underlying assets that could be actively traded on the financial markets. Henry Kaufman describes the process as "[v]ery likely the most far-reaching development in modern finance". According to Kaufman, "securitization has changed the very nature of financial assets, as well as the character of financial behaviour".[247] In consequence, the development of securitization has had enormous ramifications upon the structure of America's financial economy.

Securitization introduced to the financial markets a greatly expanded variety of assets that could be continuously bought and sold. "Thanks to securitization" Kaufman

[244] Ibid, P.81
[245] Dodd, 'Derivatives Markets', P.156
[246] Karl Beitel, 'The Subprime Debacle' in *Monthly Review*, Vol.60, No.1, May 2008, P.28
[247] Kaufman, *On Money and Markets*, P.53

observed, formerly non-marketable "assets can be traded, priced, and marked to market daily – as Eurodollar bonds, interest rate and currency swaps, junk bonds, zero coupon bonds, equity derivatives, options in Eurodollar and US Treasury futures, and in many, many other forms". Securitization has thus opened up "literally trillions of dollars worth of financial assets" to valuation by the financial marketplace. "For a long time, traditional institutions such as banks and insurance companies carried their nonmarketable financial assets (such as loans and mortgages) at par, regardless of interest rate movements".[248] However now that these securitized assets have been reconfigured into tradable items, their values are now determined by the decisions of market traders. Thus, like derivatives, the process of securitization has greatly expanded the level of volatility among American financial markets.

For Kaufman, "the most important" implication of the securitization process is the fact that "widespread securitization has had the broad effect of loosening the credit process". According to Kaufman, "[c]redit standards have been lowered, and the credit market has grown enormously" following the widespread adoption of securitization.[249] Because securitization provides banks the opportunity to package up loans and sell these off onto the secondary securities market, American banks now have a commercial interest in expanding the number of loans they give out as credit, as loan origination enables them to increase the number of marketable assets they have to sell to the securities markets. In this way large investment banks have been transformed into giant financial intermediaries, with securitization enabling them to sell off their banking responsibilities to outside investors.

Banking profitability is now primarily generated through the collection of fees from facilitating the transactions of these securitized loans. According to the scholar Karl Beitel, banks "realize profits on the fees they charge for services provided in underwriting this type of debt, for example, the purchase and aggregation of loans, the creation and sale of securities on the secondary market, and the management of the pass-through of the underlying mortgage payments to final purchasers".[250] This has come to replace the traditional banking method of maintaining profitability through the margin differences that exist between the banks' cost of borrowing and its rate of

[248] Kaufman, *On Money and Markets*, P.54

[249] Ibid, P.53

[250] Beitel, 'The Subprime Debacle', P.29

lending.[251] As such, securitization has had an enormous influence upon the type of activity now undertaken by banks within the country's financial sector.

This change in the way in which banks now make their money is one of the main causative factors behind the relaxation of credit standards from the mid-1990s on. According to Kaufman (who observed this trend during his time at the American investment bank Salomon Brothers), since a banker's fee now "depends on the successful distribution of the issue [selling the loan on through securitization]… the investment banker's due diligence is limited by his analytical focus on the borrower's current financial situation". Kaufman argues that this "in effect, leaves much of the judgement in the hands of the investor" as the purchaser of the security. However, the investor's confidence in his own financial position is in turn elevated by the securitization process. "A securitized investment… encourages the investor to believe that he can quickly sell the obligation when a credit problem brews, thereby passing the problem off to someone else". This belief, Kaufman argues, gave rise to the "liquidity illusion", where it was believed that there would always be another investor to buy the security, if the financial prospects of the current holder started to appear thin.[252]

The Federal Reserve Financial Stimulus Strategy

The exponential growth of the financial sector during the 1990s, along with the massive expansion in its activities through the rise of the secondary markets for securities and derivatives, elevated the importance of this sector in the generation of growth inside the United States economy. According to the scholar Kevin Phillips, the "torrent of new debt-related instruments and borrowing was central in lifting the relative weight of financial services from some 15 percent of GDP in 1980 to 20 percent in 2000". Indeed, this growth "gave the financial services industry essential wherewithal to consolidate its gains in share of GDP and soon to displace the toppled technology sector as the leader in US stockmarket capitalisation". [253]

In 2000, the speculative process of financialisation finally came unstuck, precipitating a serious recession within the United States economy from 2001 to 2002. According to Robert Brenner, beginning "in March 2000, a string of disastrous

[251] Kaufman, *On Money and Markets*, P.327
[252] Ibid, P.57
[253] Kevin Phillips, *American Theocracy: The Perils and Politics of Radical Religion, Oil and Borrowed Money in the Twenty-First Century*, New York: Viking, 2006, PP 330-331

corporate profit reports set off a long, deep plunge of equity prices that would ultimately by September 2002, bring the S&P 500 and NASDAQ indexes down by 185 and 400 percent respectively".[254] As we have seen, the country's productive sector had been gutted by the cost-reducing drive of the preceding boom. This decline in productive capacity, along with the even deeper decline in global aggregate demand as the emergence of even more export-oriented countries stepped up the level of aggressive-price competition found within the world's export markets, meant that any stimulus directed through the productive sector would prove to be a massive undertaking. In this regards, any stimulus measures directed through the country's productive sector would have a long lead time and would thus be unable to generate a rapid recovery from the ensuing recession.

Recognising this fact, the governing authorities saw that the quickest method of stimulating an economic recovery within the United States was through the recently enlarged financial sector. Conveniently, targeting this sector as the source of economic stimulus closely conformed to the ideological doctrine of the 'trickle-down' theory of economics, which had become widely institutionalised within government departments by this point. Moreover, as it was the crash of the financial markets that had caused the onset of the recession, a financial stimulus was believed to address this root cause and thus quickly re-orient the US economy back upon an upwards trajectory of growth. According to Beitel, as "equity prices declined, concerns emerged that the massive write-down of the (nominal) value of the portfolios of financial speculators threatened to pull the entire economy into a downward spiral".[255] Providing another market for financial speculation would therefore prevent (or as we shall see postpone) the financial markets themselves from crashing and thus from pulling the rest of the economy down into a debilitating depression. However with the sharemarkets that had constituted the underlying basis for the last phase of financial enlargement now in rapid decline, a new form of underlying asset class was required in order to derive financial devices from for speculative trading within the secondary markets. The answer to this predicament came in the form of housing.

Following the first major systemic decline of the sharemarkets in late 2000, the Federal Reserve reduced the federal funds rate "from 6.5 percent to 3.5 percent within

[254] Robert Brenner, 'What is Good for Goldman Sachs is Good for America: The Origins of the Current Crisis', 18 Apr 2009, on http://www.escholarship.org/uc/item/0sg0782h%3Cbr?display=all
[255] Beitel, 'The Subprime Debacle', P.30

the space of just a few months". In 2002, the rate was dropped again to 2 percent, and was further reduced to 1 percent by 2003. According to the financial scholar Charles R. Morris, this constituted "the lowest rate in half a century". Interest rates remained in the range of 1 to 2 percent until late 2004. Thus for "thirty-one consecutive months the base inflation-adjusted short-term interest rate was negative. For bankers, in other words, money was free".[256]

Kevin Phillips, a former Republican Party strategist, argues that the maintenance of these historically low rates of interest was part of an "underlying Washington strategy… to create a low interest rate boom in real estate". It was hoped that by lowering interest rates, this would expand access to mortgage credit to more sectors of American households. This would thereby raise "the percentage of American home ownership, ballooning the price of homes, and allowing householders to take out some of that increase through low-cost refinancing". In consequence, Phillips argues, this credit-driven housing boom "created new wealth to take the place of that destroyed in the 2000 to 2002 stockmarket crash and simultaneously raised consumer confidence".[257]

Mortgage-backed Securities and Collateralized Debt Obligations

The financial developments that had given rise to credit derivatives and the process of securitisation helped facilitate the financial stimulus strategy of the Federal Reserve Board. Investment banks found that they were able to capitalise on the increase in mortgage originations in this period, by purchasing these loans and transforming them into bond-like assets called mortgage-backed securities (MBS).Thus through securitization, banks were able to commodify mortgage loans into tradable assets and then use these assets to create a new secondary market to replace the one for equity derivatives that was then undergoing a state of decline following the sharemarket crash of 2000.

The secondary market for mortgage-backed securities experienced exponential growth throughout the following years. According to Beitel, mortgage-backed securities were "one of the largest financial asset classes by outstanding volume… bought and

[256] Morris, *The Two Trillion Dollar* Meltdown, P.58

[257] Phillips, *American Theocracy*, P.278

sold on US capital markets [May 2008]". Moreover, these instruments came to constitute "the major conduits of funding for new mortgage loans" throughout the first decade of the twenty-first century.[258]

From these mortgage-backed securities, a number of new credit derivatives were created, whose formation worked to expand the level of financial trading associated with these underlying securitized assets. Of these new forms of credit derivatives, the "most prevalent" was the collateralized debt obligation (CDO).[259] A CDO is a credit derivative that is created through a Wall Street investment bank or a government-sponsored entity (Fannie Mae or Freddie Mac), purchasing large numbers of MBS, and then categorizing these securities into different tranches, in accordance with the amount of risk contained in each group. Each tranche of MBS are then ranked with the least-at-risk at the top and the most-at-risk at the bottom. From this categorization a system of risk-mitigation is established whereby the lowest tranche will be the first to absorb any losses from loan defaults of the underlying mortgages. Once this lowest tranches has absorbed all losses within its capacity, the next lowest tranche will be the category to absorb all losses and so on. In this way the highest tranche of CDOs will be 'insured' by the risk absorption of the lowest tranches. For their part, the lowest tranches will generate a higher return for their investors, in order to compensate for the amount of risk that these CDOs hold.[260]

In this way mortgage loans were transformed into securities that resembled the form of corporate bonds. These bond-like instruments were then categorised into tranches as CDOs, which aimed to cater to a range of tastes throughout the investment spectrum, from the risk-averse interests of the pension funds to the risky yet high-yielding interests of the hedge fund investors. Beitel states that "CDOs have been promoted by their sponsors as vehicles that provide investors with a greater range of investment options by allowing fund managers to more readily recalibrate the relative balance of risk and return in their portfolios".[261] In this way a secondary market was created for mortgage loans, which replaced the secondary financial market that had been derived from the sharemarket boom of the 1990s.

Thus, even though the profitability of the country's productive sector had been incapacitated by the impact of the 2001 recession, the growth of the financial sector was

[258] Beitel, 'The Subprime Debacle', P.29
[259] Ibid
[260] Ibid
[261] Ibid

enabled to continue at a heightened pace. It was now clearer than ever that financial growth had become completely cut off from real material growth inside the country's productive economy. Economic growth in the United States during the first decade of the twenty-first century was overwhelmingly based on financial speculation, fuelled by cheap credit.

But if the funds backing this financial growth were not coming from the country's productive sector, where indeed was this cheap credit coming from? The answer to this question is the same source it had been coming from since the mid-1970s; from foreign investors and sovereign central banks, looking for a location both to appreciate their financial wealth, and also as a means to maintain the low valuation of their currencies against that of the US dollar. It was in this way that the financialisation of the US economy was inextricably linked to the wider processes of globalisation within the world economy at large.

The Foreign Source of US Credit

The great expansion in foreign financing of the US financial sector during the first decade of the twenty-first century was primarily fuelled from the corresponding rise of East Asian economies (especially China) and their strategy of purchasing large amounts of dollar-denominated assets in order to increase the price competitiveness of their exports inside the American consumer market. According to Brenner "East Asian governments' unending purchases of dollar-denominated assets, with the goal of keeping the value of their currencies down, the competitiveness of their manufacturing up, and the borrowing and purchasing power of US consumers increasing, made for a rising supply of subsidized loans" into the United States during this period.[262]

Indeed these central bank purchases were markedly increased in the aftermath of the South East Asian currency crisis of 1998. According to the scholar Raama Vasudevan "capital inflow through the 1990's was accompanied by increases in reserves as emerging markets increased their precautionary holdings of foreign reserves in order to insulate their economies of capital flight after the experience of the Asian crisis".[263] The increase in dollar reserve holdings by these East Asian governments correspondingly increased the amount of capital that flooded into the US financial

[262] Brenner, 'What is Good for Goldman Sachs', P.2

[263] Ramaa Vasudevan, 'Dollar Hegemony, Financialization, and the Credit Crisis', in *Review of Radical Political Economics,* Vol.41, No.3, September 2009, P.300

sector in order to purchase these dollar-denominated assets. In fact, "[r]eserve holdings by developing countries rose to about $2.7 trillion (37 percent of US GDP) in 2007". Consequently, "the United States absorbed 34 percent of global capital imports in 1995 and now absorbs 65 percent of global capital imports". This indeed signifies a substantial increase in foreign funds into the United States' financial sector, providing the capital base that enabled the financial expansion to occur, irrespective of the decline in earnings from the country's productive sector.[264]

The Federal Reserve's strategy of lowering short-term interest rates in order to fuel a financial boom through the housing market was ultimately dependent upon a corresponding decline in long-term interest rates during this period. This long-term decline had largely come about due to the increased inflows of capital into the country's financial sector from East Asian central banks from the mid-1990s on. According to Brenner "the Federal Reserve's campaign to bring down short-term interest rates was incapable by itself of insuring a recovery". This was because "it could not directly bring about a reduction in the 30 year fixed mortgage interest rate that was still standard in the US housing market". Changes in this mortgage rate "were determined by long-term interest rates dependent in turn on the supply and demand for loanable funds in the world economy as a whole, which the Federal Reserve could certainly affect but could not fully determine". In the ten year interval between 1995 and 2005 "the yield on 10 year Treasury bonds fell more or less steadily… declining in this interval from 7.09 per cent to 4.29 per cent in nominal terms and 4.49 per cent to 0.89 per cent in real terms".[265]

The initial impact of the rapid succession of short-term interest rate reductions by the Federal Reserve threatened to place an enormous strain upon the American economy's ability to effectively recover from the recession. According to Brenner, when "US economic authorities sharply reduced short-term interest rates and vastly increased the federal budget deficit, they rendered US dollar-denominated assets even less attractive than otherwise and risked a flight of capital that would push up long-term interest rates, force down asset prices, and end up squelching the recovery". Indeed "during 2002, a serious run on the dollar did begin to materialise and the real interest rate on 10 year Treasury's rose".[266]

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[264] Ibid
[265] Brenner, 'What is Good for Goldman Sachs', P.36
[266] Ibid, P.65

However in the interests of maintaining the export market that their economic growth was ultimately dependent on, East Asian central banks took actions that ultimately trumped the decisions of private investors during this period. According to Brenner "as they had during the first half of the 1980s under similar circumstances, Japanese economic authorities saved the day by unleashing an unprecedented wave of purchases of dollar-denominated assets". Brenner's statistics reveal that between "the start of 2003 and the first quarter of 2004, with their activity reaching a peak around June 2003, Japan's monetary authorities created 35 trillion yen, equivalent to roughly 1 per cent of world GDP, and used it to buy $320 billion of government bonds and GSE [Government Sponsored Enterprise] debt. This was "enough to cover 77 per cent of the US budget deficit during fiscal year 2004".[267]

In addition to this exponential expansion of Japanese-sourced capital to the United States financial sector, Brenner shows that between "2003 and 2004, East Asian governments taken together increased their dollar reserves by $465 billion and $507 billion, respectively". This equalled "enough to cover 90 per cent and 75 per cent, respectively, of the US current account deficit in those years".[268] It was these capital inflows that enabled the long-term rate of interest to continue to decline, providing cheap credit to fuel the financial-driven boom.

Credit-driven Consumerism

The cheaper credit provided by the low interest rates, along with the greater accessibility to mortgage finance, generated an enlarged source of credit for Americans to access for purposes of consumption. In this way easy-access credit came to replace wage growth as the pre-eminent source of consumer demand in the United States during the first decade of the twenty-first century. The change in the source of consumer demand is clearly revealed by the fact that "between 2000 and 2004, household debt grew by 39 percent, whereas "[r]eal disposable income… showed very little growth".[269] Moreover, in "2005 macroeconomist Stephanie Pomboy explained that over the three previous years consumers had leaned more heavily on new borrowings

[267] Ibid, P.51
[268] Ibid
[269] Phillips, *American Theocracy*, P.327

($675 of non-mortgage debt) than on paychecks (up only $530 billion) to make possible the overall $1.3 trillion increase in their spending".[270]

Increased access to consumer credit was in large part an offshoot of the Federal Reserve's interest rate reduction stimulus strategy. The ability of credit card companies to borrow at an interest rate hovering around the range of 1 to 2 percent provided these companies with the means to offer very attractive initial rates of interest to new customers. Despite these initial low rates of interest however, credit card companies were still able to substantially increase their profits during this period, primarily through an extension of fees and penalties. Indeed, "[a]ccording to CBS News, the portion of credit card-issuer profits represented by fees jumped from 28 percent in 2000 to 33 percent in 2002, 35 percent in 2003, and an estimated 39 percent in 2004".[271] Furthermore Kevin Phillips found that "once the new enrolee was hooked, the card companies were free to raise rates on just about any pretext – often from 6 or 11 percent into the 20 to 30 percent range".[272]

As a result, once all the fees and rate rises are accounted for, credit cards became a progressively more expensive source of credit for consumers. This is revealed by the fact that between "1990 to 2003 the number of people holding credit cards jumped by 75 percent – from 82 million to 144 million – but the amount actually charged exploded by 350 percent, up from $338 billion to $1.5 trillion".[273] At surface value therefore, credit cards appeared to be a cheap and thus affordable source of credit for consumers, but the hidden fees and penalties ensured that they were in fact a major contributing factor to the great explosion of personal debt during this period.

Along with credit cards, greater access to mortgage finance was increasingly relied upon to fuel consumption throughout this period. Responding to the massive appreciation in the valuation of their homes, many households believed that they could rely on their appreciating house value to do the saving for them. This wide-spread belief was reflected in the substantial reductions in the amount of savings found in traditional bank saving deposits during this period. According to Brenner, personal savings rates "continued at or near the postwar lows registered during the later 1990s, reaching its second lowest level since 1945 in 2006, at -0.6 percent".[274] The fact that it was the

[270] Ibid
[271] Ibid
[272] Ibid
[273] Ibid
[274] Brenner, 'What is Good for Goldman Sachs', P.38

appreciation in the value of their homes that was encouraging this reduction in personal savings is demonstrated by the fact that those “households that took out home equity lines of credit (HELOC) in this interval entirely accounted for the decline, their rate of savings dropping from -6.6 percent to -11.3 per cent”. As a result, during “the brief period between 2000 and 2007, household debt doubled”.[275]

It is important to note that a large proportion of this credit-fuelled consumption was not spent on extravagant purchases; rather it was employed as a means to cover basic living costs that were now unable to be covered by income alone, due to the stagnation in real wages since the early 1980s. For example, in regards to health costs, from“2001 [to 2007], health premiums have risen 78 percent while wages have only gained 19 percent”.[276] This problem is further compounded by the corporate abrogation from paying out employee benefits. In the past employers would “cover almost all of an employee’s health-care bills. Now workers are shelling out an average of $3,281 from their paychecks for family coverage”.[277] Indeed, across the board, basic living costs have been rising in relation to the wages of American workers. According to Phillips, “mortgage, childcare, health insurance, car and taxes – have been consuming more and more of the “discretionary” remainder of family income”.[278]

The increasing use of debt to finance spending on these necessary living costs has in turn generated yet another increase in the cost of living for American households. We have already seen how the use of credit cards enacted a considerable cost on US households during this period. The strategy of masking the true cost of borrowing by the card companies was replicated by the majority of other credit-lending institutions throughout the United States. For example, “according to the Federal Deposit Insurance Corporation and the National Credit Union Administration”, in the year 2004 alone, “banks, thrifts and credit unions collected a record $37.8 billion in service charges on accounts, more than double what they received in 1994”.[279] The scholar Michael Perelman states that “Banks continue to raise fees for late payments, low balances, and over-the limit charges to as much as $39 per violation. Some banks even charge for speaking with a service representative”.[280] In total, Kevin Phillips found that “the

[275] Ibid
[276] Kevin Phillips, *Bad Money: Reckless Finance, Failed Politics, and the Global Crisis of Global Capitalism*, New York: Viking Penguin 2008, P.87
[277] Ibid
[278] Ibid, P.99
[279] Michael Perelman, *The Confiscation of American Prosperity: From Right-Wing Extremism and Economic Ideology to the Next Great Depression*, New York: Palgrave MacMillan, 2007, P.6
[280] Ibid

percentage of household disposable income spent on debt service – principally mortgage, auto loan and credit card debt – had risen from just over 10 percent in 1983 to 14.5 percent in 2006”.[281]

Another factor that was exacerbating the credit bubble inside the United States was the fact that this debt-induced consumer demand was not fuelling the profitability of the country’s productive sector but rather that of its primary competitors. As highlighted by a CNN/*Money* analysis, “the chart of the current account gap as a percentage of GDP, incidentally, looks almost like a chart of consumer credit as a percentage of income”.[282] American households were increasing their individual personal debt in order to increase the profitability of foreign producers, who due to their offshore location, held no prospect for enlarging employment within the United States itself. As such this debt was ultimately unsustainable, as it held no stimulus measures that could be used to increase the real earnings of American workers and thus provide them with a means to pay back this debt at a later date. The only way this debt-driven spending could be recycled back into the US economy was through the financial sector, via the purchasing of dollar-denominated assets by the central banks of these producing nations. Therefore the only way American households would see their spending recycled was through an increase in credit by the country’s financial sector. However in such a situation, an increase in credit merely works to expand the country’s total debt rather than providing a means to reduce it.

Therefore, this credit-driven consumption system operated in the exact opposite manner of the wage-growth demand function of the planning system. Under the planning system, the growth of wages and employment provided the disposable income for American workers to consume in the economy. This consumption provided the main source of demand for the goods of the country’s producers, who were able to utilise this growing revenue stream as a means to engage in long-term productive investment initiatives. In turn, once realised, these investment projects increased corporate productivity and profitability, providing these companies with the material means to take on more workers, along with increasing workers wages, thus instituting a further boost to the consumer demand that was fuelling economic growth during these years. Thus rather than expand debt, the planning system worked to reduce America’s dependence on it. This independence from the financial sector, applied to both consumers *and* producers within the economy.

[281] Phillips, *Bad Money*, P.99
[282] Phillips, *American Theocracy*, P.323

The State of the Real Economy

Aside from the financial services industry, the only other economic sector experiencing significant growth in the decade of the 2000's was that of retail. According to Brenner:

> The long-standing dependence of retail trade for its own expansion on the growth of domestic manufacturing had been broken by the rocketing currency and the rise of East Asia during the second half of the 1990s. Thanks to the continuing rise of private consumption expenditures, as well as the record breaking increase of imports, especially from China, it continued to do very well in the 2000's.[283]

As we saw in Chapter Three, the profitability of the giant retail corporations was achieved in a way that structurally undermined the profitability of the domestic manufacturing sector. In addition, as these retail giants become the predominant employer among the majority of American communities, their employment practices helped to systematise the establishment of a low wage economy inside the United States of America. With these developments in mind, it is clear that the growing profitability of the retail sector - far from being a sign of sustainable growth for the American economy - was in fact an indication of the extent of decline of the country's real economy.

Thus the larger the retail sector grew during this period, the stronger the entrenchment of the structural barriers that were suppressing wage growth and undermining productive profitability within the country at this time. These problems were further compounded by the fact that the growth of the retail sector was overwhelmingly due to the corresponding expansion of consumer credit underway at this time. What was required to pay back this borrowed credit was enlarged wage-growth and productive investment within the American economy. Rather than being suppressed, these vitally important economic factors needed to be grown if the United States was to break its unsustainable reliance on debt as the main means of economic growth within the country. Indeed the fact that they were undermined largely accounts for the poor economic growth levels experienced by the country's real economy during this period.

[283] Brenner, 'What is Good for Goldman Sachs', P.66

Even accounting for the dramatic expansion in consumer credit and the spin-off stimulus effects from the housing bubble, the levels of economic growth achieved in the decade of the 2000's were extremely low by historical standards. For the "first five years of the business cycle", from 2000 to 2005, economic growth "averaged just 2.3 percent" per annum. This level of growth for the US economy was "markedly lower than any other comparable period during the postwar epoch". Furthermore, of this growth, "the bubbling housing sector, by way of its effect in raising expenditures on personal consumption and on home construction and home furnishings accounted, on average, for no less than 0.7 percentage points per annum or about 30 percent of total GDP increase during the interval". In addition, it also "accounted for at least 50 per cent of all jobs created in these years". Therefore had "it not been for housing, the average annual increase of GDP between 2000 and 2005 would have been a miniscule 1.6 per cent – even despite the soaring federal budget deficits in this period – and employment would have been strongly in the negative".[284]

Moreover in this same five year timeframe, "the increase of both non-residential investment and net exports was less than zero". This meant that "personal consumption and residential investment were left to drive the economy virtually by themselves". The structural implications of this was that for "the business cycle as a whole (2001-2007 inclusive), not only was GDP increases by far the worst since 1945, but so was the increase of plant, equipment and software, of employment, of total real compensation and of net exports".[285] Therefore, in terms of actual material growth achieved during this business cycle, the record was abysmal. Any increase in wealth during this period was primarily driven by a speculative induced appreciation of financial assets, an appreciation that was bound to crash owing to the poor prospects of the underlying real economy during this period.

In fact all that the lowering of short-term interest rates and the expansion in credit had managed to achieve for the bulk of the country's corporate sector was to further intensify the crash-inducing process of financialisation. According to Brenner, during the 2000's, corporations "sought to benefit from the depressed cost of borrowing and historic run ups of asset prices, including eventually corporate equities, by allocating their profits in unprecedented proportions to the purchase of financial assets, not least their own shares, and used much of what remained to fund dividend payouts to

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[284] Ibid, P.62

[285] Ibid

stockholders".[286] As we saw in Chapter Three, this process was severely debilitating for the conditions of the country's underlying productive economy, suppressing the aggregate demand functions of wage growth and the initiation of innovative long-term investment projects. The intensification of financialisation in this period therefore, seriously undermined the vitality of the country's real economy.

The debilitating impact of financialisation during this period is clearly illustrated by the fact that throughout the 2001-2007 business cycle, manufacturing corporations "continually shed employees, bringing about by 2007 an unprecedented loss of 3.3 million workers, or 20 per cent of the manufacturing labour force". The impact on aggregate demand of these reductions was further compounded by the fact that these same companies "managed to hold the growth of real compensation per employee to 1.3 per cent compared to 1.4 per cent between 1990 and 2000. The consequence of this suppression was that "over the course of the business cycle, *total* real compensation in the manufacturing sector (number of employees × compensation), which had increased at an average annual rate of 1.05 per cent during the 1990s cycle, actually declined at an average annual rate of 1.9 per cent".[287] As we have seen, this reduction in employee benefits meant that households had to turn to increased borrowing as a means to maintain living standards during this period.

In regards to the state of productive investment during the business cycle, "manufacturing investment, which had increased at an average annual rate of 5 per cent during the 1990s cycle, collapsed, falling at an average annual rate of 2 per cent, with the consequence that the manufacturing capital stock (plant, equipment, software) actually contracted by 2.5 per cent".[288] As a result of the above two processes, domestic aggregate demand took a tremendous hit during this decade.

In consequence, due to the considerable decrease of real aggregate demand, credit-driven consumption and the inter-related speculation of the housing market was overwhelmingly relied upon to stimulate economic growth within the United States during the 2000's. In fact "consumption and residential investment together accounted for 98 per cent of the growth of GDP that took place during the length of the business cycle".[289] As such, with the dearth of real earnings, the 2000's business cycle was almost completely reliant on the growing access to consumers of debt-inducing credit

[286] Ibid, P.63
[287] Ibid, P.64
[288] Ibid
[289] Ibid, P.70

and the speculative appreciation of the housing market, both of which constituted highly unsustainable pillars from which to base the growth of an advanced economy upon.

The Expansion of Subprime Mortgages

Throughout the business cycle, residential mortgages continued to be extended to poorer and poorer segments of the American population. In the process, this credit extension enabled the speculative-driven house-price appreciation to continue at a heightened pace. "Never before in postwar history", Brenner states, "had housing risen for any significant interval faster than prices in general or than rents. Yet, between 1998 and 2006, they had increased in real terms by 68 per cent".[290]

Due to the decline in long-term interest rates, it had become progressively harder for banks to generate a profit from the traditional strategy of borrowing cheap in the short term and lending dear in the long term. Indeed the profitability of this traditional strategy became increasingly untenable from 2005 on, after the Federal Reserve increased short term interest rates (in a pre-emptive move against inflation) while long term rates continued to decline (in accordance with the constant inflow of foreign funds into the US financial sector). With the generalised decline in yields from long-term lending, the main means to maintain profitability for American banks was to purchase mortgages that had been originated from riskier and riskier households, as it was these mortgages that generated the highest rate of return on the secondary market for CDOs. As such, in order to keep profits high, more and more of these high-yielding mortgages were required from the subprime sector.[291]

In order to attract new subprime borrowers, a number of measures were employed to mask the true cost of the loan these borrowers were taking out. For example "interest-only mortgages, which only required borrowers to pay interest charges and were often set at seductively low "teaser" rates, began to proliferate" during this period.[292] Likewise so did "negative amortization loans" where the borrowers monthly payments were less than the monthly interest added on to the loan. Here the difference between monthly payments and accumulated interest is capitalised back onto the principal of the loan, so that over time, the principal and the amount of interest this loan generates is actually increased. Also becoming more prevalent throughout this

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[290] Ibid,
[291] Ibid, P.56
[292] Beitel, 'The Subprime Debacle', P.32

period were adjustable rate mortgages, which involved "contracts that essentially bet on several more years of fast-rising prices".[293]

In addition, with the aim of lending to "households with limited savings, mortgage brokers began to offer no-down payment loans, lending up to the full value of the home". Towards the end of the boom, borrowers "were allowed to state their income on loan applications without lenders requiring any supporting documentation". Finally, in order to "encourage working class households to take on higher levels of debt, subprime borrowers were told not to worry about higher payments as their mortgages reset, given that they could always refinance at a later date".[294]

While of course the subprime borrowers who took on these unaffordable loans do bear an onus of responsibility for the subsequent crash, their actions must be analysed in the context of the economic environment that had emerged during the decade of the 2000s. The combination of stagnating real wages, declining employment prospects and extremely low real interest rates offered in traditional savings accounts, left the rapidly appreciating housing market as one of the only accessible outlets to improve one's economic position within the United States during this time. As such, it was not so much the reckless borrowing habits of subprime mortgage holders that brought the American economy to a standstill in late 2007, but the wider macroeconomic environment that offered no other viable alternative to economic advancement for the majority of American households.

Investment banks and other financial entities had initially turned to CDOs as a way to restore profitability in the face of declining long term yields. However the sustained demand for these CDOs meant that these packaged securities too "were soon subjected to the same bubble-driven stresses as were pressing down on the credit markets as a whole".[295] This thus rapidly reduced the returns that could be derived from these assets, relative to the amount of risk carried in each tranche of CDO. In consequence, from around 2004 on, the only means to generate higher yields was to package up mortgages from riskier and riskier borrowers, as this increased risk warranted the ability to attain a higher yield on these CDOs, in the face of a generalised decline in yields during this period.

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[293] Ibid
[294] Ibid, PP 32-33
[295] Brenner, 'What is Good for Goldman Sachs', P.55

As a result, "from 2001 to 2006, the quality of subprime loans deteriorated markedly according to every indicator. Loan-to-value ratios fell; debt to income ratios fell; and the proportion without documentation soared". Nevertheless, despite the substantial increase in the origination of ever more riskier loans, "interest rates on non-conforming mortgages, as well as the spread between subprime and prime loans, *fell* steadily throughout most of the period, inexorably determining a corresponding decline in the yields on most MBS/CMOs [collateralised mortgage obligations] that referenced them".[296]

In order to maintain financial profitability in the face of a generalised decline in the yields from lending in the US economy, investment banks engineered ever more complex tranches of CDOs. However in reality, all this added complexity was able to achieve, was to mask the risk of default of the underlying mortgage loan. Thus as the business cycle of the 2000's progressed, investment banks:

> Collateralized CDOs that were backed (for the most part) by unsold mezzanine pieces left over from collateralized CMOs, and, as the bubble got even bigger and yields still more compressed they created CDO^2 that were backed (for the most part) by unsold mezzanine pieces derived from CDOs. At the very top of the securitization bubble, some banks even issued CDO^3, CDO's of CDO's of CDO's, constituted as before by re-cycled tranches that were insufficiently attractive to be sold on a standalone basis so had to be restructured, generally so as to provide the collateral for the newly-constituted senior and equity tranches of higher-power CDOs.[297]

In this way, ever higher levels of increasingly unstable credit were built upon ever more riskier loan originations. Ironically, this process was described by its principal proponents as an advancement in financial innovation that was working to eliminate risk from the American economy. However as the empirical example of the 2008 credit crash assuredly demonstrates, this so-called financial 'innovation' achieved anything but.

Alan Greenspan, the then chairman of the Federal Reserve, claimed that this process of financial engineering constituted a "new paradigm of active credit management".[298] Greenspan, along with the other advocates of this 'innovative' strategy

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[296] Ibid, P.56
[297] Ibid
[298] Alan Greenspan cited in

argued that risk as a disruptive function had been largely removed from the American economy. This was because, it was argued, that risky assets had been distributed out to those individuals and institutions that were the most capable of bearing it. Furthermore, pieces of financial assets (through the use of credit derivatives and securitization) had been distributed out to such an extent, that if a risky loan were to default, it would only impact upon a very small section of each investor's overall portfolio of interests. However while the growing market for mortgage-backed securities was indeed distributing risk out to a great number of market players, as the market grew bigger and more and more subprime mortgages were packaged into CDOs, the more riskier of the mortgage securities began to be held in increasing numbers by the major banks. Thus while the market for securitized subprime mortgages grew, risk was disbursed throughout the system, but the greatest risk, embodied by the most recent securitized assets, became progressively concentrated in holdings linked to the biggest banks in the American economy.

The Concentration of Risk: Structured Investment Vehicles

When the secondary market for CDOs first came to play a major part in investment banks' business operations, banks would invariably line up investors for their CDO assets first, and only then, once credible buyers had been established, would they proceed to purchase loans from mortgage originators as collateral for the purposes of securitization. However at the height of the credit boom, when institutional investors' demand for CDOs had reached epic proportions, banks began to store large quantities of mortgage-backed securities in reserves, so that they could quickly supply the growing demand for these assets. These reserves were held in giant 'conduits' and 'structured investment vehicles' (SIVs), which were established with the appearance of embodying separate institutions, financially independent from their parent banks. Banks used these investment vehicles to store large amounts of MBS loans, which thus enabled the banks to remove these unsold mortgage securities as a potential liability from their balance-sheets. SIVs were intended to hold on to these unsold securities for only a short duration, until an investor had been lined up to purchase them from the bank. At "their peak in 2006 and 2007, conduits possessed a stunning $1.4 trillion in assets".[299]

[299] Brenner, 'What is Good for Goldman Sachs', P.59

As a means to maintain their financial independence from the parent banks, SIVs relied on the asset-backed commercial paper market as a source of short-term capital to purchase the MBS reserves. Commercial paper is an extremely short-term source of credit, with the loan reaching maturation within one to ninety days of its origination. Nevertheless, these debts were typically rolled over as they matured. According to Karl Beitel, as long as the "purchasers of this paper (the money market funds) are confident that borrowers are solvent, debts are typically rolled over at maturity at the prevailing interest rate".[300]

As a condition for borrowing from the short-term commercial paper market, each SIV was "required to secure a back-up line of credit from the sponsoring bank as insurance in the event that the SIV does not have sufficient cash on hand to settle these obligations at the time they come due". Thus even though these large reserves of unsold securities were placed off the balance sheet of the major investment banks, their obligation to bail out these SIVs if need be, ensured that these large reserves remained a significant liability for the major American banks, regardless of what their balance sheets had stated at the time.

The use of SIVs and financial conduits greatly expanded the amount of trading done with mortgage-backed securities. Beitel states that much "of the explosive growth in mortgage credit after 2005 reflected the entry of SIVs as a major new supplier of housing finance". In fact, "subprime lending jumped from an annual volume of $145 billion in 2005 to $625 billion in 2006".[301] The problem with this SIV-driven expansion was that the SIVs "operate on razor thin margins".[302] These tight margins heavily increased the liability these institutions held for their parent banks, as it meant that the SIVs were highly vulnerable to both a drop in demand for mortgage-backed securities, along with any increases made in the cost of borrowing from the short-term commercial paper markets. Incidentally, it was pressures coming from both sides of the investment equation that helped contribute to the crash of the subprime sector, in the process exacerbating the consequences of the fallout throughout the financial economy of the United States of America.

[300] Beitel, 'The Subprime Debacle', P.31
[301] Ibid, P.32
[302] Brenner, 'What is Good for Goldman Sachs', P.60

The Crash of the Subprime Sector

In late 2005 the Federal Reserve increased interest rates "in a pre emptive strike against inflation". This meant that as interest rates rose in response to the increase in the federal funds rate, "a growing number of "teaser" rate loans started to reset accordingly".[303] Since domestic demand in these years was primarily driven by cheap-credit fuelled consumption and property appreciation based on highly leveraged speculation, this slight rise in interest rates helped contribute to a general slowdown in economic growth throughout 2006 and 2007. The net effect of this slowdown was to further reduce the earnings capacity of subprime borrowers to meet their recently elevated monthly mortgage repayments.

According to Brenner, "the descent into recession was already well into progress before the outbreak of the financial crisis in July-August 2007". This is illustrated by the fact that non-financial "corporate profits peaked with housing prices in the middle of 2006 and then declined by 10 per cent by the third quarter of 2007. In addition, during "the first half of 2007, already-weak jobs growth had fallen by 50 per cent compared to 2005 to 2006". Also, in the "second quarter of 2007, the increase in real cash flowing into households, which had run at about 4.4 per cent in 2005 and 2006, fell to near zero".[304]

Thus by the first half of 2007, the precarious position of subprime households had progressively worsened. With their homes beginning to rapidly lose value at the same time as their monthly mortgages repayments became much more of an intense burden to bear, the number of loan defaults emanating from the subprime sector increased accordingly. Aided by their ability to effortlessly switch positions in the market, institutional investors rushed to reduce their exposure to mortgage-backed financial assets. In the process, this worked to reverse the massive inflow of financial liquidity that had fuelled the viability of subprime lending. A number of high-profile meltdowns of subprime mortgage originators increased the stampede out of the market. On 2nd April 2007, New Century Financial, "the largest US subprime lender", filed for bankruptcy under Chapter 11 status, American Home Mortgage followed suit at the beginning of August. "This was followed in rapid succession by several high profile

[303] Beitel, 'The Subprime Debacle', P.34
[304] Brenner, 'What is Good for Goldman Sachs', P.71

meltdowns in Europe, with the UK-based Northern Rock Bank and BNP Paribus, the French banking group, both taking major hits to their mortgage-backed portfolios”.[305]

With the mass rush out of mortgage-backed securities, the collateral SIVs had used to borrow from the commercial paper markets had become essentially worthless. In response the money “market funds began to refuse to roll over the SIV’s commercial paper”.[306] This meant that the parent banks were now committed to supplying a large amount of credit to these investment vehicles, in order to meet the SIV’s outstanding obligations to the commercial paper market. As a result, the large Wall Street banks were forced to considerably curtail their lending activity, in order to have enough funds to meet these maturing obligations in the face of the massive depreciation in the value of their main class of financial asset – the mortgage-backed security. This problem was further compounded by the fact that the complex tranching and re-tranching of CDOs, meant that investment banks’ were finding it extremely difficult to accurately calculate how much exposure their underlying assets had to the collapse of the subprime mortgage sector. It was this uncertainty that led to the considerable contraction in lending during the second half of 2007.

According to Beitel, “[d]espite the officially quoted rates on overnight federal fund and LIBOR (London Inter-Bank Offer on short-term funds borrowed in the Euromarket), banks were engaged in rationing short-term credit, refusing to lend to even other ostensibly solvent multinational financial institutions”.[307] Credit – the lifeblood of the financialised economy of the 2000’s – had effectively dried up. It was this great contraction in credit, starting in late 2007, that exposed the United States to the realities of the serious suppression of wage-determined demand and the debilitating decline in the country’s productive capacity. It was the great credit contraction of 2007 therefore, that finally revealed the façade of financialisation for what it was.

[305] Beitel, ‘The Subprime Debacle’, P.35
[306] Ibid
[307] Ibid

Conclusion

In conclusion, the substantial enlargement of the financial sector during the sharemarket boom of the 1990s elevated the position of the industry to one of prime importance within the US economy. New forms of financial devices were engineered in order to rapidly expand the amount of trading done within the sector, significantly enlarging the size of the financial sector in the process. Two of the most prevalent devices employed to enlarge the size and scope of the sector were credit derivatives and the process of securitization. Credit derivatives greatly expanded the amount of trading that could be undertaken on any individual asset; while securitization substantially expanded the number of underlying assets that could be traded upon within the financial system.

Financial expansion ensured that after the country's corporate sector had collapsed following the sharemarket crash of 2000, the financial sector had the ability to rapidly reorient itself towards another asset class and thus continue its self-generating speculative boom. This reorientation was directed towards the housing sector, a move that had been facilitated by the series of short-term interest rate reductions implemented by the Federal Reserve, who aimed to stimulate a credit-driven recovery through an expansion of mortgage finance throughout the economy. Increased mortgage originations provided an asset class that investment banks could securitize into MBS, which could then be pooled together into CDOs as a means to cater to the range of portfolio interests throughout the investment spectrum.

The financial sector continued to expand its wealth despite the dramatic deterioration of the country's productive economy. This situation, where financial liquidity undergoes spectacular expansion while the productive economy experiences an accelerated decline, contains an inherent contradiction that is unable to be explained from a solely domestically-focused analysis. Indeed, this inherent contradiction is especially evident when one considers both the duration and extent of financial speculation in generating economic growth within the United States in these years. As such, the only way that the financialisation of the US economy can be properly understood is by looking at the larger imbalances that exist in the world economy taken as a whole.

The export-oriented strategy of economic development that Japan and West Germany first employed in the 1970s has come to be adopted by the great majority of other countries trading within the world economy. In consequence, the process of globalisation has worked to generate an international system based on aggressive price competition. This manifestation has exponentially increased the amount of suppliers within the system, while simultaneously instituting downward pressures upon the growth of aggregate demand at the international level. With more and more countries entering the global economy, the United States has been increasingly relied upon to provide the consumer demand for this increase in international suppliers. However, the cost-cutting drive of financialisation has worked to effectively decrease the amount of real aggregate demand found within the US economy, as determined by wage growth and the initiation of long-term productive investments. As such, an expansion in the amount of credit available to American consumers has been used as a means to address the great deficiency of aggregate demand that exists in both the United States and the global economy taken as a whole.

As exemplified by the 2008 crash of the US economy, this foreign-financed credit expansion is ultimately unsustainable. With constant inflows of foreign funds reducing the cost of credit within the US economy, the price of long-term lending experienced a generalised decline. This meant that the traditional strategy of borrowing short cheap and lending long dear was proving increasingly unprofitable for the financial institutions that relied on this strategy. As a result, most major banks turned to the selling of CDOs, (especially the selling of the higher earning yet riskier CDOs composed of subprime mortgage holdings) on the secondary markets as their main means of profit generation within this period.

However with the availability of credit experiencing exponential expansion, while that of wage earnings and employment opportunities were in a state of decline, the number of households who could not afford to maintain their interest payments on their mortgage commitments rapidly increased, expanding the size of the subprime sector in the process. Consequently defaults within this sector increased substantially, especially after the interest on adjustable rate mortgages was raised in response to the Federal Reserve interest rate hike in 2005.

The crash of the subprime sector, which had overwhelmingly been relied upon as the main means of profitability by the major investment banks during the later years of the boom, generated a widespread contraction in lending by the majority of financial institutions operating within the US economy. This credit crunch largely eliminated the access to cheap credit that had been fuelling the financialised growth of the US economy throughout the decade of the 2000's. As a result, a serious recession quickly subsumed the American economy in 2008.

The overwhelming dependence of most exporting nations on the credit-driven demand of the US economy has meant that the recession of the United States has had serious ramifications for the global economy taken as a whole. The interrelated nature of the issue means that for an effective solution to be reached, an internationally based response is required. In particular, the severe deficiency of global aggregate demand must be addressed by the world's nations if a sustainable system of economic growth is to be established at the international level. This is vital if economic globalisation is to depart from its contemporary 'race to the bottom' trend.

Conclusion

The Issues

If the current recession is to be comprehensively understood, it must be analysed through a wider analytical paradigm in order to illustrate the complete chain of causation that brought the US economy to this debilitating predicament. For the current recession represents far more than just a business downturn caused by the collapse of the subprime mortgage sector. The Great Recession of our time has been caused by the inherent contradiction that exists between the expansion of speculative credit and the suppression of productive wage growth via the process of financialisation, which has been in place in the United States' economy since the beginning of the 1980s.

A major catalyst for the current recession is the disproportionate dependence of the US economy on financial-centred wealth generation over that of productive based growth. As evident in the empirical example of the planning system, an economy geared towards material productivity as the penultimate source of economic growth embodies a progressive system of capitalism, one that is centred on high-road labour relations and the technological advancement of the wider society. In contrast, the opposing system of financialisation systematises the establishment of a low wage economy, along with rendering innovative-inducing productive based investments an unattainable endeavour.

The fact of the matter is that innovative new technologies do have long lead times to create and manufacture and as such require a level of planning and organisation, which in turn requires a degree of stability that a disproportionate dependence on financial market growth is unable to provide. The ideology of neo-classical economics claims that the most efficient allocation of economic resources is to allow economic growth to be determined by the 'free market'. In the empirical example of the contemporary economy of the United States however, this 'market' has come to embody the financial markets, and as we have seen, this market allocation has involved sucking resources out of the productive economy in order to fuel speculation inside the financial sector.

This misallocation of economic resources was clearly evident in the cost-cutting corporate drive of the 1990s, as American corporations tried to progressively reduce costs so as to boost short term profitability in order to appreciate the price of their shares on the financial markets. Thus the unfettered allocation of economic resources by the free (financial) markets generates a mass misallocation of productive resources, destroying large amounts of wealth in the process, as evident in the series of speculative driven financial crashes that have increased in both intensity and frequency since the financialisation trend was first initiated in the beginning of the 1980s.

From the analysis of the planning system, it is arguably clear that the productive markets are the most effective market mechanisms for allocating economic resources. However these productive markets, in order to prove profitable throughout a long-term trajectory, operate on fundamentally different criteria than that which facilitates the speculative induced growth of the financial markets. Fundamentally, both market forms of growth – productive and financial – require a different role for the government in the economy.

In the analysis of the planning system we saw how there was a clear role for the government in the American economy. This role was most effectively exercised in the provision of a stable customer that enabled the dominant manufacturing corporations to initiate research and development of innovative new technologies without bearing any unnecessary risk. In the absence of these government contracts, the uncertainty inherent in these innovative technological developments would have rendered these investments commercially unfeasible for the corporations concerned.

Many of the technologies that were used to generate initial excitement in the sharemarkets from the second half of the 1990s were technologies whose development history could be clearly traced back to this government sponsorship. The overarching influence of financialisation during this same decade however, ensured that this innovative development largely stagnated from this point on, as ever increasing amounts of capital were directed towards financial speculation rather than technological development within the productive sector. The stability that the American government provided for the initiation of innovative technological advancement thus embodies the most effective form of risk mitigation within the American economy during the postwar period. This government sponsored system was ultimately far more effective than the 'active credit management paradigm' that was pursued during the financialised period of the 2000s, which ultimately proved ineffective in preventing the financial crash of 2008.

Another system of risk mitigation that the system of financialisation proved unable to replicate, was the complicit consent shared by the dominant corporations of the postwar planning system to refrain from engaging in aggressive price competition in their commercial strategies. This agreement enabled the establishment of a high-road economic model within the United States of America. In this high-road model, wage-growth embodied an important function of demand and as such was encouraged rather than suppressed (as under the contemporary anti-inflationary stance of monetarism). Throughout the period of the planning system, wage growth was able to be accommodated through the role of organised labour. Trade unions ensured that wage rises were shared industry-wide, enabling increased labour costs to be passed on to consumers, whose demand in turn was ultimately dependent upon the growth of wage earnings throughout this period. In this way domestic demand was self-generating, ensuring sustainable economic growth in the process.

In direct contrast, the role of government from the 1980s on has encouraged the establishment of a low wage system to be implemented inside the United States economy. One of the most prevalent ways in which neo-classical inspired government policies have worked to influence the spread of this development has been through the turn to monetarism in the 1980s. The elevation of monetary policy as the primary mechanism used by the government to influence conditions of the macroeconomy has proved disastrous for the commercial viability of the country's productive economy.

The primary problem for American industry during the 1970s was the dramatic increase of suppliers in the US markets, following the rise of Japan and West German exporters during this period. Due to the suppression of their own domestic demand as part of their export-oriented strategy, international supply increased exponentially during this period without a corresponding expansion in the level of aggregate demand at the global level in order to accommodate the impact of these new market players. The primary problem in the early 1980s was therefore one of insufficient demand, not supply.

The Monetarist diagnosis of this situation however, was that American supply had been rendered uncompetitive due to the supposedly inflated levels of demand that had prevailed in the economy from government fiscal policies, which had worked to protect American industry from the full competitive forces of the free market. The monetarist solution was to further depress demand in the American economy, by raising interest rates in order to engineer a domestic recession. This self-induced recession was argued to constitute a necessary step by its principal proponents, who believed that the US economy was inflicted by inflated levels of demand (or what these theorists referred to as an artificially inflated money supply). As a result, monetary policy exacerbated the serious gap that had opened up between supply and demand in both the international economy and that of the United States itself. As such, its net effect was to have long-term ramifications for the subsequent structure of the United States' economy.

The high interest rate strategy of monetarism improved the attraction of the financial sector as an investment outlet over that of the productive sector. The competitiveness of America's productive industries were dramatically reduced by the appreciation of the dollar, as international investors rushed to purchase dollar-denominated assets in order to capitalise on the high interest rates offered in the country. The financial sector thus benefited from the Federal Reserve's monetary policy through the increase in funds to its sector from international investors, while the capital earnings of the productive sector were further reduced due to their decline in competitiveness from the effective increase in the price of their products via the appreciation of the dollar vis-à-vis that of their primary competitors. It was this evident bias towards the financial sector, inherent in the Federal Reserve's monetary policy, which led to the emergence of financial-led growth – or financialisation – from the 1980s on. The rise of financialised growth came at the great expense of the country's productive economy.

The American government continued to facilitate the growth bias of the financial sector by targeting stimulus measures through the Federal Reserve rather than through congressional fiscal policies of demand management. In 2001, monetary policy was used as a stimulus (in 1980 it had been used as a handbrake) to generate an economic recovery from the recession that followed the crash of the corporate sharemarkets. Financial stimulus was generated through the lowering of interest rates in order to reduce the costs of borrowing throughout the US economy. This expanded Americans' access to credit and thus compensated for the shortfall in aggregate demand that had been instigated by the decline of real wages and the withdrawal from productive investment throughout the previous decade.

The sole reliance on monetary policy to stimulate the economy however, meant that the cheap credit that this policy induced was ultimately unsustainable. For a point of contrast, Keynesian fiscal policies generate real material improvements from which future economic growth can be based upon. Government contracts initiate the development of innovative technologies that carry the ability to increase employment and advance the technological sophistication of American society into the future.

Likewise, increased public sector employment, both improves the skills of the country's workforce and raises aggregate demand through a rise in wage earnings, reducing the dependence of American households upon debt in the process.

In contrast, the cheap credit generated through the monetary stimulus strategy of the Federal Reserve encouraged financial speculation, which was ultimately dependent upon a growing stream of even cheaper credit to sustain. As a result, this speculation, rather than stimulate the productive economy back to a position whereby it could generate the earnings to repay this accumulated credit, worked to further intensify the process of financialisation, which as we have seen, operated by sucking capital out of the productive economy in order to fuel speculation in the financial sector. Monetary policy therefore exacerbated the severe imbalance that existed between the expansion of credit and the decline of wage earnings that was responsible for the unsustainable ballooning of the credit bubble during the decade of the 2000's. What was really required were active Keynesian fiscal policies, which work to increase the profitability of the productive sector in order to generate real earnings for the American economy. The provision of cheap credit, while it provided a quick fix from the 2001 recession, was only able to address the superficial symptoms of this recession and thus proved ineffective (in fact it exacerbated) the root cause of the problem, which was an excessive dependence on debt, due to the dramatic decline of the productive economy to generate enough earnings to maintain the aggregate demand that was required to keep both the United States and the world economy at large from falling into a debilitating recession.

One of the principal catalysts behind this excessive debt dependence has been the sustained purchasing of dollar-denominated assets by sovereign central banks. This has facilitated a massive inflow of credit into the United States, thus intensifying the financialisation process, generated as it was during the 2000s by the accessibility of cheap credit. As we have seen, these inflows inhibit the profitability of the productive economy whilst enabling a cheap source of credit to fuel speculation within the financial sector. Thus if a productive based recovery is to be generated inside the United States - in order to avoid the crash-inducing trappings of a financial based recovery - then the artificial appreciation of the US dollar must be addressed within the international economic environment.

The need to address this issue calls for a more active stance by national governments in the workings of the international economy. Recent history shows that when this task has been attempted - for example the active intervention undertaken by national governments in the foreign exchange markets during the days of the Plaza Accord - this has been achieved with a measure of success. Indeed the main barrier to more effective inter-governmental coordination on international economic issues has been the institutionalisation of the neoliberal ideology within international economic organisations and national government departments alike.

Neo-classical economics actively discourages effective inter-governmental coordination by theorising that the most efficient situation at the aggregate level is to allow market forces to dictate themselves. However, as the Keynesian tradition demonstrated during the 1940s, often the most efficient solution taken at the micro level works to create an environment of low profitability at the macro level. If economic activity is to be sustainably elevated onto the international stage, then effective inter-governmental coordination must be undertaken in order to prevent such a regressive situation from emerging. Indeed, it is arguably clear that such a situation has already developed within the international economy, as the dominant national model of export-oriented development has worked to increase supply and suppress aggregate demand within the international environment, thus precipitating a system of economic globalisation that has been characterised by contemporary scholars as embodying a ‘race to the bottom’, mutually disruptive to all participants.

Therefore, the main barrier to the establishment of a more progressive international political economy is the institutional adherence to the defunct principles of neo-classical economics. The ideology of neo-classical economics argues that in order to create competitive conditions of supply, commercial industry must be unfettered to feel the full forces of the free market. However, as the recent history of the US economy clearly illustrates, these so-called free market pressures primarily compel producers to compete on price, resulting in cost-cutting drives, demand suppression and the establishment of a low wage employment model. In contrast, the economic environment of the planning system highlights the vitally important role Keynesian demand management policies play in generating sustainable economic growth. Keynesian policies encourage the growth of effective demand that enables the establishment of a high-road economic model centred on technological advancement and innovative production, along with the generalised improvement in the economic position of the mass majority of individuals within this capitalist system.

The postwar American planning system, which had generated near-continuous economic growth for twenty years, came unstuck with the increasing internationalisation of economic relations during the 1970s. The neo-classical school of thought interpreted this development to embody the ultimate failing of the Keynesian tradition. In contrast, this paper argues that it was not the failings of the domestic Keynesian system, but that of the wider unregulated international environment that enabled unbridled price competition to trump the coordination of the United States' planning system. The failing of the Keynesian system of demand management was not due to an internally flawed logic as neo-classical theorists maintain. Rather domestic Keynesianism was undermined by a larger international economic environment, whose unfettered nature from effective inter-governmental regulation rendered it more in accord with the neo-classical vision of economic relations.

The inability of domestically-oriented demand management policies to effectively function within a larger international economic environment governed by unfettered capital was a potential problem that Keynes himself had recognised during the development of his theories. It was for this reason that Keynes stressed the need for national capital controls as part of the international economic framework that was agreed upon at Bretton Woods. As we have seen, the need to maintain a low currency following the relaxation of these currency controls from the mid 1960s on, has been one of the primary reasons why domestic demand has been suppressed within export-oriented nations. At the international level, this domestic demand suppression by the majority of nations practising export-oriented economic growth strategies has culminated in the manifestation of insufficient international demand to support the substantial increase in suppliers throughout the global economy. It is the emergence of this significant imbalance that has resulted in the severe global recession of the contemporary period.

What Needs to be Addressed: The Domestic Situation

A change in the ideology surrounding the institutional analysis of international economic issues needs to be undertaken if an effective solution to the current global recession is to be reached. The primary problem within the global economy today is the highly insufficient level of aggregate demand that exists at the international level. However, the neo-classical ideology that now influences economic policy-making at both domestic and international levels is centred on a dogmatic adherence to instituting measures of economic efficiency in order to improve competitive conditions of supply. These so-called efficiency endeavours however, in practice, merely improve competitiveness through regressive price reductions rather than quality improvements or the initiation of innovative production. In the aggregate, these cost-reductions exacerbate the problem of insufficient international demand and thus intensify the primary problem within the global economy. From a macroeconomic perspective, the ideology of neo-classical economics has inspired an extremely debilitating trend for the direction of contemporary globalisation, culminating in the severe recession that currently inflicts the global economy. Indeed there is a clear causation from the undermining of Keynesian demand management policies inside the United States, to the adoption of neo-classical economics, to the productive decline of the US economy, financial speculation, economic instability and the onset of the Great Recession of the contemporary period.

In regards to the domestic economy of the United States, it is clear that the process of financialisation is an unstable system of economic growth, which from a long-term macroeconomic perspective is proving highly debilitating for the health of the country's real economy. A move is required for a return to the more sustainable planning system of capitalist growth. This will ensure that economic growth benefits a far greater spread of Americans than the inequality inducing system of financialisation is able to provide. In addition, this will also ensure that the United States experiences heightened technological progression, rather than materially stagnating as vast swathes of potentially productive capital is wasted through unsustainable speculation within the financial sector.

In recent years there have emerged a number of rising environmental concerns that require an innovative technological approach to effectively address. Neoliberal theory defines these pressing problems as mere 'externalities'. However for the capitalist system to be environmentally sustainable into the long-term, a more proactive approach is required. Fortunately a more proactive approach can be employed as part of a Keynesian fiscal stimulus strategy to the contemporary recession, producing economic benefits (rather than external impacts) for the United States' economy in the process.

For instance, rather than government research contracts only being provided to firms specialising in military technology, government sponsorship could be provided to firms who specialise in developing technologies that address these pressing environmental concerns. This would generate a far more productive capitalist based solution to these problems than the current market based trading approach (which can only really stem the speed of the rate in which these 'externalities' impact upon the human population rather than generating a proactive solution in addressing the root cause of the problem) is able to provide. A wider range of government contracts will once again accelerate the technological advancement of the United States economy. They will provide a viable outlet for talented Americans to direct their energies towards, rather than this talent being subsumed within the socially disruptive speculative-driven financial sector.

If earnings are to effectively replace credit-driven demand as a means to reduce America's unsustainable debt-dependence, it is vital that the low wage economy of the United States is effectively addressed. The prevalence of this low wage economy increases the pressure on producers to engage in price-based competition. Furthermore, as we saw in Chapter Four, many American households depended on debt to cover their basic living costs. With the contraction in lending from the current credit crunch, it is vital that American incomes are increased to cover these costs and reduce the unsustainable dependence on debt.

The need for an economy-wide increase in wages, calls for a renewed role for industrial trade unions within the American economy. This is required in order for these wage rises to be adopted at an industry-wide level and thus not put any dissenting firm at an unfair cost advantage. The problem of free-riding can also be eliminated by an increase in minimum wage rates through federal legislation. This will contribute immensely towards the establishment of a high-road employment model within the United States. The establishment of this employment model will generate the necessary domestic demand function of wage growth, which will reduce the country's unsustainable dependence on debt and financial speculation to achieve economic growth.

In order for the cost of wage increases to initially be commercially viable for American companies, an injection of demand stimulus is required by the federal government, so that companies have the initial demand to allow them to increase employment and raise wages, which will in turn provide a further boost to aggregate demand, kicking in a self-reinforcing economic expansion in the process. In order for this government demand to stimulate productive growth rather than financial speculation, the most productive outlet for this government stimulus is through increased public sector employment. It is essential that this employment spreads throughout the industrial spectrum, from the research and development of new technologies through to blue-collar based positions. This will decrease the bargaining power of exploitative employers, such as the retail giants, within American communities, while also eliminating the pressures that are forcing many Americans to abandon socially important public sector jobs in favour of financial sector employment. Ultimately, this initial injection of demand-management will create the conditions for a more dynamic and prosperous American society, in contrast to the precarious and unequal nature of the financialised system that has dominated economic relations over the last thirty years.

What Needs to be Addressed: The International Situation

Like the situation in the 1970s, the ultimate barrier to the successful implementation of a productive based Keynesian-demand stimulus strategy is the unfettered nature of the international economic environment. In order for domestic Keynesianism to be successful, it must be extended to the wider international economy, otherwise it will ultimately be undermined. The specifics of such a development are beyond the parameters of this paper to discuss, but the locomotive strategy of the Carter administration in the late 1970s offers a useful starting point. Whatever the specifics, it is clear that there must be considerably more inter-governmental coordination in raising aggregate demand at the international level, if each national economy is to escape from the debilitating ‘race to the bottom’ trend of contemporary globalisation.

At the level of the individual firm, a business strategy must be realised that is not dependent on the regressive reduction of costs. Multinational firms need to start looking at foreign locations not as a cheap source of labour, but as a potential consumer market for their products, which could be used to increase their long-term revenue streams and thus provide more capital to engage in innovative productive investment projects, reducing their dependence on debt-derived growth in the process. The only way to grow these consumer markets is for these firms to pay their outsourced workers a wage that provides them with the disposable income to purchase the firm’s products. With all multinational firms following this strategy, this will substantially increase the amount of demand within the global economy and thus eliminate a large amount of the problem that is currently afflicting the global economic environment. The mass production that the economic system of capitalism is ultimately centred on is only commercially viable if there exists a sizable market for mass consumption. If mass production is to be extended to the international level by multinational firms then mass consumption must also be expanded through the wage growth of the workers who are generating this increased production.

A New Role for Government in the International Political Economy

Therefore, in stark contrast to the assertions of neoliberal economic theory, what is required in the contemporary period is a greater role for the government in the economy. In regards to the case study of the United States, despite the proclamations of the 'active credit management paradigm', it has been the American government, not the 'free market', that has assumed the overwhelming responsibility for the unaffordable risk taken on by the financial sector. The American government has a democratic responsibility to the ordinary tax payers whose funds were used to bail out the bankrupt banks of the financial sector to ensure that the economic recovery operates in a manner that materially benefits the population of the United States taken as a whole, not just the financial elite, whose prominence has only served to impoverish workers and suppress the technological advancement of American society.

It is thus the democratic responsibility of the American government to ensure that it provides a return to the taxpayers who are financing the current recovery. The most effective means through which this can be achieved is through the implementation of Keynesian fiscal policies, as a replacement to the financially-oriented monetary stimulus strategy of the Federal Reserve. This will ensure that the American economy recovers in a way that is beneficial to the great majority of Americans who are sponsoring the recovery through their taxes, rather than just to the financial elite, whose reckless speculation and destructive expropriation of vital capital from the productive sector caused the crash of the US economy to begin with.

The US government also needs to adopt a different role within the international arena. Rather than supporting the neo-classical policy positions of the WTO, the World Bank and the IMF, whose collective pressures are exacerbating the problem of insufficient demand at the global level, the American government needs to exercise its diplomatic leverage and work with other nations to formulate an effective strategy to raise global aggregate demand into the future. The potential of any such strategy being undermined by corporate free-riders necessitates the formulation of an effective normative regime within the international economy. Capitalism has always required a degree of governance to ensure that it does not descend into a destructive drive towards aggressive price competition (for the end result would be monopoly, or commercial totalitarianism, not dynamic capitalism). As such, if economic activity is to be extended onto the international arena, then it is vital that so too does political governance via increased inter-governmental coordination over international economic issues.

This task however, is greatly hindered by the pre-dominance of neoliberalism in orthodox economic thinking. The neoliberal position regards the analysis of economic relations as an exact science that is unable to be disturbed by political involvement. It is for this reason why neo-classical economics has proved an inadequate guide for analysing the current recession and why a more comprehensive policy debate is required in order to generate more effective solutions to the current recession. For it is only through an expansion in the contemporary debate beyond that of the limitations of the neoliberal paradigm that the macroeconomic imbalance between supply and demand at the international level can be recognised. It is clear that the neoliberal position, with its preoccupation in microeconomic conditions of supply, is fundamentally flawed as a paradigm from which to analyse both the current recession and the deeper issues of the contemporary international political economy.

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