The Boom, the Bubble, and the Future

Interview with Robert Brenner

In his new book, The Boom and the Bubble: The U.S. in the World Economy *(Verso, 2002), UCLA historian Robert Brenner presents a view of economic events over the past quarter century that both conservatives and liberals can disagree with. But in a time when few have made cogent sense of the recent past, Brenner presents one of the most comprehensive analyses available. He believes that capital investment and profitability are the prime source of economic dynamism in general and productivity growth in particular.*

Q. Our objective in this interview is to get a sense of whether you think the current economic recovery and expansion is durable. But to begin, we should discuss the long economic decline between 1973 and 1995. What were the principal causes of this decline, in your view?

A. Essentially, the long downturn resulted from the sharp fall of the profit rate and the long time it took to recover. This development was itself largely rooted in the decline, and failure

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Challenge, vol. 45, no. 4, July/August 2002, pp. 6–19.
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ISSN 0577–5132 / 2002 $9.50 + 0.00.

to recover, of the profit rate in manufacturing alone. What initially caused the drop in the manufacturing rate of profit was a profound intensification of competition in the international manufacturing sector between 1965 and 1973, which resulted in overcapacity and overproduction systemwide. Lower-cost, higher-profit producers from Japan and western Europe entered into the world market and imposed their lower prices, reducing the ability of high-cost producers to mark up over their costs. (By profit rate, I mean profits net of depreciation divided by net capital stock.)

Initially, the fall in profitability in international manufacturing was located in the United States, but, following the sharp devaluation of the dollar between 1971 and 1973, the manufacturing sectors of the other leading advanced capitalist economies were also obliged to shoulder a good part of the burden. The fall in the profit rate—perhaps 25–30 percent in aggregate—was not confined to the United States, but affected the advanced capitalist economies taken together, and reduced profitability persisted for two decades or more. The result was reduced investment and output growth, thus reduced productivity growth and, in turn, reduced wage growth and elevated rates of unemployment, from 1973 through 1993 and beyond.

Q. But why did the downturn persist?

A. That is a good question. Given that the problem was overcapacity, one might reasonably expect that capital would have shifted out of oversubscribed, low-profit lines into others where it could get a better return. But, instead, for the most part, the leading firms across the advanced capitalist world found it made better sense to fight rather than to switch. They had huge masses of "proprietary" capital—in the form of relations with suppliers and customers and, especially, technological capability—that they could use only in their own industry. They therefore sought to respond to intensified competition not so much by reallocating means of production to other industries as by themselves investing so as to cut costs in order to produce

the same goods more profitably. Meanwhile, newly emerging producers in parts of the third world—especially East Asia, but also, in the 1970s, in places like Brazil and Mexico—found that, with their far lower wage costs, they could profitably enter into even oversupplied lines.

The overall outcome was not enough exit and too much entry, exacerbating the initial problem of overcapacity and overproduction. Ironically, Keynesian public deficits made this situation possible. It was only the huge subsidy to demand made possible by the turn to heavy government borrowing across the advanced capitalist world that allowed the global economy to keep turning over and to maintain stability through the end of the 1970s.

Q How did Reaganomics affect economic prospects?

A. [Federal Reserve chairman Paul] Volcker's huge interest-rate increases at the end of the 1970s and start of the 1980s were meant, in the first instance, to defeat inflation. But they were aimed, more fundamentally, at restoring profitability by shaking out the huge ledge of high-cost, low-profit means of production that was the legacy of the Keynesian 1970s, as well as, of course, by raising unemployment so as to reduce the growth of real wages. But these measures were, in a sense, *too* successful, because the recession they provoked led by 1982 to the danger of depression. The ensuing third world debt crisis threatened to bring down the leading banks and provoke a financial collapse.

Q. And then the Reagan tax cuts?

A. Yes. Ironically, what allowed for the maintenance of growth and stability over the course of the 1980s was the implementation of Reagan's record Keynesian deficits, created by tax cuts for the corporations as well as military spending increases.

It was, in a sense, politically impossible to allow the huge liquidation of means of production via depression that had been

the way the system historically had prepared the way for new booms. But the cost of keeping the system turning over through big deficits was, first, the maintenance of a large amount of high-cost, low-profit means of production that should have been forced out of operation, and, second and most important, the persistence of record-high real interest rates. It was high real interest rates, plus the failure of profitability to rise above its reduced levels at the end of the 1970s, that made for the continuation of slowed growth through the end of the 1980s.

Q Some claim that the issue is technological. They say the reason for slowed growth was that our old technologies based on electricity were exhausted and new technologies had yet to mature. You seem to believe that technology is simply there for the taking. I am not so optimistic. Do you think, for example, that computer prices would have fallen as fast in the early 1990s under different circumstances? Would great new standardized products have proliferated as rapidly? Do you disbelieve the Paul David idea that technologies require time to mature?

A. In the first place, if the exhaustion of innovation had been responsible for the long downturn after 1973, one would have expected a pattern of slow decline of productivity growth leading up to it, as technological opportunities were used up. In fact, all across the advanced capitalist economies, productivity growth maintained itself, even increased, throughout the first postwar quarter century. Indeed, productivity growth during the 1960s was at its highest level of the postwar period and showed little if any sign of decline right through 1973. So there was little indication of technological exhaustion.

Second, studies by Zvi Griliches of Harvard and others, designed to explore the technological roots—if any—of the decline in productivity growth after 1973, found no evidence of

decline in the pace of invention. By contrast, there was obviously a decline in the rate of *adoption* of the techniques that were available. I would attribute this result to the decline across the world system of the rate of investment growth—which was itself responsive to the reduction in profitability—as well as to the decline in the growth of demand for both capital goods and consumer goods that accompanied reduced investment growth.

Third, it looks to me as if the main technologies that made for rapid growth in the second half of the 1990s had long been available—for example, the computer and the Internet, not to mention computer-aided production and design, mini-mills, and so forth.

The economy's greater dynamism resulted from the faster adoption of the available new techniques, which was the consequence of the acceleration of investment from 1993 to 1994. As was to be expected, the rapid growth of investment made for more rapid productivity advance not only through the faster implementation of existing inventions, but also by speeding up the achievement of economies of scale and learning by doing. Of course, the faster growth of investment was itself made possible by the revival of the profit rate.

To put the point another way, I do not believe that technological changes happen so discontinuously that they can explain an economic expansion such as occurred more or less suddenly after 1993. But the sudden onset of rapid investment growth, like that which occurred at that time, *can* explain the rapid exploitation of technological opportunities. Moreover, the mere introduction of cost-cutting techniques cannot ensure increased profitability, for its benefits can accrue to the consumer in the form of lower prices. Yet higher profit rates *will* accelerate innovation by making for more rapid capital accumulation. Indeed, the introduction of powerful technologies was incapable of sustaining the expansion of the 1990s for very long, precisely because it generally brought lower prices, rather than higher profit rates.

Without the stock market bubble, the boom would have ended long before it did, despite the new technology.

Q You write in your new book that the fall in the U.S. dollar from 1985 through 1995 was a major turning point. Why?

A. The reason is that it played a big part in allowing the U.S. manufacturing sector to increase its competitiveness and thereby to begin to increase its profitability. As I said, reduced manufacturing profitability had been the ultimate source of the secularly reduced growth of investment and output, and the fall in manufacturing profitability had itself been largely the result of the intensification of international competition. To make matters worse, a super-high dollar, resulting from Reagan-Volcker's initially elevated real interest rates, had further reduced U.S. competitiveness, and profitability, between 1980 and 1985, by raising export and reducing import prices enormously. So, when Reagan and the G-5 powers agreed in 1985 to the Plaza Accord, they opened the way to 40–60 percent reductions of the dollar vis-à-vis the yen and mark, and the huge reduction in relative costs was able to provide the initial basis for a U.S. manufacturing revival.

Q At that point, profitability for manufacturing began to rise. But let me understand your basic economic point of view. Why are profits the key variable for economic growth—the key determinant?

A. The profit rate is the key to the economy's health because it is the key to the growth of investment. Higher profit rates make for higher available surpluses. Moreover, because the system is unplanned and unpredictable, companies have little choice but to regard the realized rate of profit as the best available indicator of the investment climate, the expected rate of profit.

Finally, if you hold the dispersion of profit rates constant, a reduced profit rate implies that a greater proportion of firms are on the verge of bankruptcy, so that the economy is more vulnerable to shocks.

Q. But what about demand? Isn't the growth of demand responsible for both high profit rates and high rates of investment?

A. Leaving aside the government, I see the growth of demand in the private sector as basically resulting from the growth of investment, dependent upon the profit rate. The growth of investment creates both the growth of employment and, by way of the growth of employment and the growth of productivity, the growth of real wages. So, the growth of investment creates the growth of demand both for capital goods—plant and equipment—and for consumer goods.

Q But there were other factors that affected profitability in the late 1980s and early 1990s, in addition to the exchange rate.

A. Yes, there were. In addition to the devaluation of the dollar, U.S. manufacturers were able to benefit from reduced costs in a whole series of ways. First, real wage growth was held close to zero for the decade after 1985. Second, from the early 1980s, firms benefited from a very major reduction in the corporate tax rate. Third, perhaps because the growth of inflation was ultimately slowed, real long-term interest rates fell sharply.

I should add that the manufacturing sector also benefited from very major shakeouts of high-cost, low-profit means of production in this period, especially in the extended recessions of the early 1980s and early 1990s.

The outcome was that, by around 1993–94, having benefited from a big reduction in the exchange rate, a virtual "freeze" on real wage growth, and reduced real interest rates—and

having gotten rid of many redundant means of production—the U.S. manufacturing sector had experienced a huge increase in its potential rate of return. It was this outcome that set off the boom in investment that was the key to the boom of the 1990s.

Q If profitability began rising in manufacturing in the 1980s, why didn't the sector invest more aggressively in information technology in those years?

A. Actually, manufacturing profitability did not begin to rise until 1987, especially as a response to the sharp decline of the dollar the previous year. Investment growth did begin to increase significantly soon thereafter. Indeed, in 1988 and 1989, the growth of investment in information-processing equipment averaged 10 percent per year. This recovery might have sustained itself, but it was cut short by the recession of 1990, brought about by Alan Greenspan's interest-rate increases.

On the other hand, by the end of the 1980s, industrial corporations had gotten themselves deeply in debt as a consequence of the financial engineering, the mergers and acquisitions, of the previous decade. Their debt burden might well have limited their dynamism. As it was, they were profoundly threatened by the recession. But Greenspan and the Fed bailed them out by reducing real interest rates from about 5 percent to zero in a very short space of time. This was a major factor in preparing the way for the expansion.

Q Why didn't services profitability rise in this same period?

A. That is a good question, to which I wish I could supply a better answer. It is something I am working on now. Still, I should say, first, that profitability outside of manufacturing

never fell to anywhere near the extent it did in manufacturing. Whereas the manufacturing profit rate was more than 50 percent below its average of the postwar boom during much of the 1980s, nonmanufacturing profitability was only about 20 percent below.

One important reason, though not the only one, that the economy outside manufacturing did relatively poorly in the period when manufacturing profitability recovered between 1985 and 1995 is that the same low dollar of this period that made manufacturing more competitive and sharply raised the cost of imported goods, squeezed wholesalers, retailers, and others that relied on inputs from overseas. By the same token, when the dollar again rose, beginning in 1995, the nonmanufacturing profit rate rose in tandem.

Q. You believe the Federal Reserve stunted potential growth in 1993. But was it not plausible that inflation was still a threat?

A. As I read the numbers, price inflation had been *falling* significantly right up to the time Greenspan raised rates—that is, in both 1992 and 1993—vis-à-vis not only the late 1980s but also the recession years of 1990 and 1991. Indeed, inflation *continued* to fall in 1994 even as growth speeded up and unemployment continued to decline (the interest rate increases did not hit the economy until late 1994). So, it is hardly evident that the United States was in danger of runaway price increases.

I think Greenspan was, more or less dogmatically, invoking the so-called NAIRU [non-accelerating inflation rate of unemployment] theory, which sees prices as accelerating when unemployment dips below a certain point. When Greenspan took action, unemployment was, if I remember properly, still well above 6 percent, but it had fallen a good deal and growth had accelerated, so he lowered the boom. In any case, I do not think

that Greenspan's action should be given much credit for sustaining economic dynamism. This was a function, in the first instance, of the recovery of profitability and, secondly, after 1995, of the wealth effect of the rising stock market.

Q. Please explain further what you think produced the boom. Was it just the recovery of profitability?

A. The recovery of the U.S. profit rate did provide the initial basis for the expansion, through 1995–97. Nevertheless, the ability of the profit-rate recovery to sustain itself was never ensured. The main reason for this is that the obverse side of the U.S. manufacturing revival was a manufacturing crisis in Japan and western Europe. These economies were hurt by the very developments that opened the way to the U.S. recovery between 1985 and 1995. They were hit, in the first place, by the sharply rising values of their currencies and rapidly rising wages vis-à-vis those in the United States. They were hurt, too, by the fact that a real, sustained investment boom in the United States was delayed until 1993–94, with the result that, until that point, the growth of U.S. demand for the goods of its leading trading partners and rivals was very slow growing. In the meantime, U.S. producers restored their rate of return to a large degree simply by appropriating market share from and imposing their lower prices upon their Japanese and western European competitors. Finally, the Japanese and western Europeans were hurt by the fact that, from 1993, the United States under Clinton refused to play its accustomed role of incurring budget deficits to jumpstart the U.S. and world economy and instead turned to balanced budgets. This was a huge demand shock to Japan and western Europe.

The upshot was that, during the first half of the 1990s, while the U.S. recovery got under way, the Japanese and western European economies experienced their worst recessions of the

postwar period. Indeed, by spring 1995, as the yen rose to 79 to the U.S. dollar, the Japanese manufacturing economy appeared to be freezing up. U.S. policymakers had just been burned by the Mexican peso crisis. They therefore felt they could not risk the possible consequences of a Japanese collapse. With the "reverse Plaza Accord," the U.S. government, in cooperation with Germany and Japan, therefore sought to push up the U.S. currency and push down the yen and the mark. The ensuing rise of the dollar was the turning point for the world economy in the 1990s, for it put an end to the revival of U.S. manufacturing profitability, the fundamental basis for the U.S. boom, while also opening the way to the stock market bubble.

Q. You explain that the dollar took flight in 1995, with the result that by 1997 the profit rate began to fall. Why did capital investment keep rising rapidly and the expansion speed up?

A. As a result of the same rising dollar that reduced U.S. manufacturing competitiveness and profitability—and also as part of the process by which the G-3 governments pushed up the dollar—money flooded into the United States beginning in 1995, rapidly pushing down long-term interest rates. With credit eased, and the international value of stocks going up, investors naturally poured money into the stock market. Until 1995, stock prices had risen in accord with profits, but from that point the growth of equity values far outran underlying earnings. Nevertheless, with their on-paper assets hugely inflated, both corporations and wealthy households were able to access funds incredibly cheaply. Corporations were therefore able to maintain the boom in investment even as the rate of return on their capital fell. Yawning disparities thus began to open up between falling profit rates, on the one hand, and the runaway stock market and booming economy on the other. Neither of these could be

sustained for very long. The stock market crashed, and, as the "wealth effect" went into reverse, the economy entered recession.

Q. So, we have a number of financial obstacles to future growth—a high dollar still, lower profitability, high levels of debt. Will these alone deter future growth?

A. It seems to me that the main, immediate barrier to growth is the huge buildup of superfluous plant and equipment that resulted from corporations' continuing to invest during the later 1990s on the basis of their easy access to capital, in the face of falling profit rates. It is due to this redundant means of production that Greenspan's huge reductions in interest rates have not brought increased investment. Indeed, investment has been falling right up to the present.

It is true that growth has been accelerating (during the fourth quarter of 2001 and the first quarter of 2002). But so far this trend has been based entirely on the very rapid growth of consumer debt, which has made possible an uptick of consumer spending and a buildup of inventories (plus some government spending). There has been no followup yet in purchases of new plant, equipment, and software.

On the other hand, with unemployment continuing to rise and household debt at an all-time high, it may doubted if the almighty consumer can continue to drive the cyclical recovery.

Perhaps most important, the two main forces that successively drove the boom—first, rising profitability, especially in manufacturing, and second, the wealth effect of the stock market bubble—are gone. The profit rate in the nonfinancial sector is today at its lowest level since the early 1980s. And, as you imply, the high dollar still constitutes a major barrier to the recovery of the profit rate in manufacturing. It seems to me that, without a revival of the profit rate, there will be no return to reasonably rapid growth.

Q Is there reason to think that things could get worse?

A. That, of course, is hard to predict. But a number of major "imbalances," the legacy of the bubble, have in no way been overcome and have the potential for bringing about disaster.

First, as you mentioned, there is the huge buildup of corporate debt. If corporations continue, as they have been, to try to restore their balance sheets by cutting back borrowing, this would obviously dim prospects for a new investment boom.

Second, there is the huge current-account imbalance. If the U.S. economy grows at all—and even if it doesn't—this is bound to get worse, as our propensity to consume and to import is far greater than that of our trading partners. Until now, the rest of the world has been happy to fund this deficit, pouring money not only into direct investment here but also into U.S. equities and corporate bonds. But, if overseas investors were to conclude—as they have already begun to do—that U.S. assets are not as good as they once looked and to rapidly liquidate their holdings, there would be huge downward pressure on the dollar. In this case, the Fed would be caught between a rock and a hard place: Either allow the dollar to fall, bringing down U.S. assets with it, or raise interest rates to stem the tide and thereby invite deeper recession.

Finally, the stock market is still highly overvalued. This seems hard to credit, but it is the case, because the reduction of equity prices has been pretty much matched by the reduction of profits. Price-earnings ratios thus remain elevated. Of course, if the stock market were to fall further, it would not only cast a pall on the expectations for the real economy, it might very well detonate the run on U.S. assets, and the dollar, mentioned above.

Q What if there is a new economy of technological power. Can it not overcome these obstacles?

A. Obviously, a huge shelf of powerful techniques that have not yet been implemented would improve prospects, all else equal. But there is no reason to count on technological power being able, in any direct way, to make for economic prosperity, for reasons given earlier. That is, while high profit rates and investment accelerate technical change, technical change cannot in itself bring about high profit rates and investment. Is that not the lesson of the later 1990s, when the accelerated introduction of information technology led not to a sustained boom but to overcapacity, major downward pressure on prices, falling profit rates, a stock market crash, and ultimately recession?

Q. What is your medium-term outlook for the U.S. economy?

A. The odds are against any near-term return to the kind of economic expansion that we had in the 1990s, and the prospects point toward slow growth, stagnation, or worse. I think this for two related reasons. First, despite appearances, it is not clear that the world economy during the 1990s definitively transcended the long downturn. During the first half of the 1990s, the U.S. recovery was overbalanced by stagnation and recession in most of the rest of the world. During the second half of the 1990s, the world economy was driven ever increasingly by the U.S. stock market bubble, not by real underlying strengths. During the decade as a whole, in terms of the basic economic indicators—the increase of GDP, productivity, investment, wages, and so forth—the G-7 economic growth rate was lower than in the 1980s, which was lower than it was in the 1970s, which was much lower than it was in the 1960s and 1950s. Second, it is not clear to me how profitability can make a strong recovery in the foreseeable future.

Q. What is your long-term outlook?

A. I have no idea.