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The Current Financial and Economic Crisis: A Systemic Crisis of Neoliberal Capitalism

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Abstract: This paper presents a case that the financial and economic crisis that began in the U.S. in 2008 indicates the start of a systemic crisis of neoliberal capitalism. The same institutional features of neoliberal capitalism that promoted a series of long economic expansions over several decades also created long-run trends that have led to a systemic crisis. Several possible future directions of economic restructuring are considered.

Keywords: neoliberalism; social structures of accumulation; crisis; asset bubble; financial fragility

1. Introduction

A financial crisis developed with remarkable speed starting in the late summer of 2008, as mortgage-related securities that had spread through the US and global financial system suddenly collapsed in value.¹ This crisis has undermined many of the largest financial institutions in the US and elsewhere, as well as severely damaging a large part of the world's financial system. Recently the financial crisis has been joined by a gathering recession in the non-financial sector in the US and global economies. This paper argues that the current financial and real sector crisis should be seen a part of larger development. That is, the current crisis should be seen as a systemic crisis of a particular form of capitalism, namely neoliberal capitalism.²

In the U.S. the signs of a systemic crisis are easy to see, in recent economic, political, and ideological developments. Output and employment in the U.S. are now falling with a

¹ It is not possible to precisely date the start of the global financial crisis, which began in the U.S. U.S. mortgage delinquencies began to rise in early 2007, producing bankruptcies among subprime mortgage lenders. In the summer of 2007 the world's major central banks undertook coordinated injections of liquidity into the world financial system. In March 2008 the investment bank Bear Stearns faced failure and was acquired by JP Morgan Chase with Fed backing, followed by an FDIC takeover of Indymac Bank in July. However, it was in early September 2008 that the term "financial crisis" came into regular use as problems in the financial system accelerated sharply, with the government takeover of Fannie Mae and Freddie Mac on Sept. 7, the forced sale of Merrill Lynch to Bank of America on Sept. 14, the failure of Lehman Brothers on Sept. 15, and the Fed's rescue of AIG on Sept. 17.

² While this paper focuses on the systemic crisis of neoliberal capitalism in the U.S., this systemic crisis appears to apply to global neoliberalism as well. However, the global dimension of this crisis is considered only tangentially in this paper.

speed not seen in many decades, and it seems that all observers expect it to get worse. Citigroup and General Motors, two of the largest corporate institutions in the US -- one the largest bank and the other a long-time symbol of US manufacturing prowess -- have approached insolvency. Policies that had been effective in surmounting past financial crises and recessions in the neoliberal era -- expansionary monetary policy along with occasional institutional bailouts -- have proved incapable of stemming this crisis.

In the realm of politics, the crisis contributed to a major electoral shift in the US in November 2008, with the electorate in practically every region of the country shifting its vote markedly toward the Democratic presidential candidate, compared to recent past presidential elections. Contrary to the experience in recent decades, the Democratic candidate won a large majority of big city newspaper endorsements and out-fundraised the Republican candidate even among many traditionally Republican business interests. In the realm of policy, many prominent economists and policy analysts have suddenly supported what amounts to the partial nationalization of major banks and a huge government stimulus program. The dominant neoliberal ideology of the past thirty years appears to have largely lost its legitimacy, and even some conservative intellectuals have abandoned it.¹

History shows that capitalism periodically undergoes a systemic crisis. The particular institutional form of capitalism has varied in different periods. However effectively a particular institutional form of capitalism, or social structure of accumulation (SSA), may for a time promote high profits and economic expansion, eventually the contradictions of that form of capitalism undermine its continuing operation, leading to a systemic crisis.²

To refer to a situation as a systemic crisis means that the crisis can be resolved only through a major restructuring of the system. If the current situation were not a systemic crisis, then it should be possible resolve the financial crisis with appropriate state bailouts of financial institutions and the imposition of some new regulations on the financial system, while mitigating the developing recession with a large economic stimulus program. Following such crisis interventions, neoliberal capitalism would resume more-or-less normal operation. However, if the current financial and economic crisis is an indication of a systemic crisis of neoliberal capitalism, that suggests that neoliberal capitalism cannot be sustained by such limited interventions, and we should expect to see the replacement of neoliberal capitalism by something else.

A systemic crisis occurred at the end of the 1920s, when an earlier liberal form of capitalism went into crisis following the stock market collapse of 1929. Another developed

1 Such public figures as Lawrence Summers and Robert Rubin, both of whom played key roles as architects of financial deregulation in the Clinton Administration in the 1990s, have recently called for more regulation of the financial sector and even for measures to reduce inequality. See Summers (2008).

2 This analysis is based on the social structure of accumulation (SSA) theory (see Kotz, McDonough, and Reich, 1994). However, the analysis presented here differs in some ways from the usual interpretation of that theory and the usual dating of SSAs in U.S. history. For the traditional view, see Gordon et al., 1982, and for a full explanation of the version of SSA analysis used here, see Wolfson and Kotz, 2009.

in the mid 1970s, as the regulated form of capitalism of the post-World War II decades stopped working effectively.¹ In both cases, the crisis was followed by a thorough restructuring of capitalism. Today it appears that we are entering another systemic crisis, this time of the neoliberal form of capitalism that dates to the late 1970s/early 1980s.

Polanyi was the first to suggest that a capitalist system tends to alternate between periods of liberalism, in which market activity is subject to little regulation, and periods in which society intervenes to actively regulate market activity (Polanyi, 2001 [1944]). Such an alternation appears to characterize US institutional history since the end of the Civil War. The 1870s to the 1890s was a Laissez Faire period known as the Robber Baron Era. This was followed by active state regulation in the "Progressive Era" of 1900-16. Liberalism characterized the period 1920-32, followed by a relatively comprehensively regulated capitalism which did not emerge fully until the late 1940s. Then neoliberalism replaced regulated capitalism starting around 1979.² The Great Depression of the 1930s was an economic crisis that developed more rapidly and was much more severe than the crisis of regulated capitalism of the 1970s. The latter developed gradually, with problems showing up after 1966 when the rate of profit began a long period of decline in the US and the major European economies.³ A full crisis broke out after 1973 when inflation spiraled out of control and the final collapse of the Bretton Wood system led to turmoil in the international monetary and financial system, lasting through the end of the 1970s. This raises the possibility that the economic crisis of a liberal form of a capitalism may in general tend to develop more rapidly and be of greater severity than a crisis of regulated capitalism. The recent experience is consistent with that proposition.

This paper has the following parts. Section 2 offers an analysis of how the neoliberal form of capitalism has been able to promote high profits and long economic expansions for several decades in the U.S. Section 3 explains how the same processes that promoted profit-making and capital accumulation laid the grounds for a systemic crisis, which broke out in 2008. Section 4 considers possible directions for institutional restructuring in the US.

2. Neoliberal Capitalism and Economic Expansion in the US

After about six years of crisis of the state regulated form of capitalism from 1973-79, a new neoliberal form of capitalism began to emerge, first in the UK and US. Neoliberal

¹ The view that regulated capitalism went into a systemic crisis in the 1970s is found in many works of the social structure of accumulation school, such as Bowles et al., 1990.

² In 1979 Margaret Thatcher took office as British Prime Minister, the same year that in the US the Carter Administration suddenly began advocating deregulation of business, reduction in taxes on business, and cutbacks in social programs.

³ The rate of profit in the USA, and for a combination of the UK, France, and Germany, declined from the mid 1960s through the end of the 1970s, at which time it began a long-term rise (Dumenil and Levy, 2004, 24, figure 3.1).

capitalism has had the following main features in the US:

1. Deregulation of business and finance, both domestically and internationally, to allow the so-called "free market" to rule and to achieve free mobility of capital.

2. Privatization of many state services which had previously been provided directly by state agencies and state employees.

3. The state no longer actively regulated the macroeconomy, and to the extent it undertook macroeconomic interventions, the aim has been to assure low inflation, not low unemployment.

4. Sharp reductions in state social spending.

5. Reduction of taxes on business and wealthy individuals.

6. Big business and the state attacked the trade unions, which transformed the labor market so that capital has been able to fully dominate labor.

7. A shift in the labor process from reliance on long-term employees to increasing use of temporary and part-time workers.

8. Unrestrained, cutthroat competition replaced the "co-respective behavior" that large corporations had practiced in postwar regulated capitalism.

9. The introduction of market principles inside large corporations, including a shift from choosing the CEO from among career employees of the firm to hiring from the outside in a market for CEOs.¹

Over time the above set of institutions gave rise to three important developments, which together promoted a series of long economic expansions but also contained the seeds of an eventual systemic crisis. These three developments are the following: 1) Growing inequality, within the capitalist process between wages and profits, and within society as a whole among households; 2) a financial sector that became increasingly absorbed in speculative and risky activities; and 3) a series of large asset bubbles.

Every one of the above neoliberal institutions contributed to the growing inequality of the neoliberal era. Deregulation of previously regulated sectors such as transportation, communication, and power led to sharp reductions in wages those sectors. Deregulation in the international arena facilitated capital flight and intensified import competition from low-wage countries. Privatization of state services often, although not always, has shifted the work to low wage employees in private contractor firms.² Giving up macro policy aimed at low unemployment led to a higher average level of unemployment, reducing workers' bargaining power. Reduction in social programs lowered the "social wage" which had previously reinforced workers' bargaining power. Reduction in taxes on business and the rich increased after-tax inequality. Perhaps most obviously, the attack on trade unions

¹ A set of new global level institutions also arose in this period, which are beyond the scope of this paper. See Kotz and McDonough, 2009.

² An exception is in U.S. military contracting, which in some cases involves shifting the "work" from relatively low-paid military servicepeople to higher-paid private employees.

undermined workers' wage bargaining power. The shift to temporary and part-time workers replaced high-wage jobs with low-wage jobs. Unrestrained competition among large corporations put downward pressure on wages. Finally, the market in CEO's caused executive salaries to skyrocket, rising from 42 times the pay an average worker in 1982 to 411 times in 2005 (AFL-CIO, 2007).¹

The second development noted above -- the increasingly speculative, high-risk activities of the financial sector -- was a product of financial deregulation, unrestrained competition, and the marketization of large corporations (see Crotty, 2008). Financial deregulation freed banks and other financial institutions to pursue whatever financial activity would bring the highest profits, which had not been allowed under the pre-1980 highly regulated financial structure. Unrestrained competition put pressure on each institution to constantly seek new, more profitable activities. The appointment of CEOs from the outside encouraged a short-run view, since now CEOs became focused on getting a few years of impressive stock market performance to facilitate moving to a higher paying job at another institution. These factors together encouraged a shift away from the traditional financial activities of taking deposits, making and holding loans to businesses and homeowners, floating bond issues, and selling conventional insurance. Much higher profits could be made in such speculative activities as creating and selling increasingly exotic instruments such as subprime and alt-A mortgages intended for securitization, collateralized debt obligations, and credit default swaps.

The third development above -- the emergence of asset bubbles -- was result of the first two developments, and thus ultimately of the whole set of neoliberal institutions. The rise in profits relative to wages, and the rising concentration of household income at the top, produces a large and growing volume of investable funds that tends to exceed the available productive investment opportunities. This creates favorable conditions for the development of asset bubbles, as such funds find their way into the purchase of assets such as real estate or securities. Once an asset bubble begins, its continued growth requires a financial system that will readily lend money to feed the bubble, which the deregulated, short-time-horizon financial sector of the neoliberal era proved ready to do. After 2000 the deregulated financial sector created new mortgage lending practices that steered a large and growing volume of borrowed funds into the purchase of housing, providing important support for the growth of the last asset bubble of this era.

Evidence for the above three developments is not difficult to find. Figure 1 shows the relation between the growth rates of labor productivity and real hourly earnings of nonsupervisory workers. Since both series are greatly affected by the business cycle, the growth rates are shown for peak to peak periods. The year 1979 is the business cycle peak just at the start of neoliberal restructuring. After two back-to-back recessions during

1 The CEO data cited are for corporations in the Standard and Poors 500.

1980-82, there followed a long economic expansion from 1982-1990. The next two business cycle peaks were in 2000 and 2007. Thus, the neoliberal era produced three relatively long expansions, from 1982-1990, 1991-2000, and 2001-07.

As figure 1 shows, output per hour rose much faster than the real earnings of nonsupervisory workers in each subperiod, with the gap growing in 2000-07 compared to 1990-2000. If output per hour rises faster than real hourly earnings, this implies a shift of income from labor to capital. By contrast, during the regulated capitalist era of 1948-73 output per hour rose at 2.4% per year while real hourly earnings of nonsupervisory workers rose almost as rapidly, at 2.2% per year.¹

Since the earnings series in figure 1 is for nonsupervisory workers only, the comparison with the productivity series assumes that other workers are paid out of surplus value. A broader measure of earnings, called real compensation per hour (which includes all employees), is shown in figure 2. The series for real compensation per hour covers all employees, including managers. Figure 2 shows that productivity growth outpaced compensation growth for each subperiod, with the gap largest in 2000-07. The same series for 1948-73 shows productivity growth at 2.8% and compensation growth at 2.7% per year.

Figure 3 provides a different indicator of the capital-labor relation in the neoliberal era. It shows the growth rate of real profits and of real compensation for the corporate business sector. This measure is suggestive of the Marxist concept of the rate of surplus value.² Figure 3 shows that profits grew significantly faster than compensation in 1979-90, which included three years of severely depressed profits in the early 1980s. In 1990-2000 profits grew faster than compensation by an even wider margin, and in 2000-07 the gap became enormous.³

Neoliberal capitalism not only brought profits that rose rapidly relative to wages but also rapidly rising inequality in the distribution of income among households. From 1979-2004 the share of the top 5% of households rose from 15.3% to 20.9% while that of the poorest 20% fell from 5.5% to 4.0% (Economic Policy Institute 2007). Toward the end of the neoliberal period to date, income growth has been particularly concentrated at the very top. In 2000 and again in 2005 the richest hundredth of one percent (0.01%) of families in the U.S. received 5% of total income, a level that had been not been reached

1 The data for 1948-73 are from Economic Report of the President 1988 pp. 298, 300. The definition of the real hourly earnings variable available for that period differs slightly from the series shown in figure 1.

2 The rate of surplus value is the ratio of surplus value to variable capital. The two variables in figure 3 differ from the related concepts in Marxist theory, in that corporate profit is a narrower variable than surplus value and employee compensation includes the pay of unproductive workers.

3 The comparison to 1948-73 is less straightforward in this case. After 1966 the rate of profit fell rapidly in the US, as the postwar system of regulated capitalism began to experience serious problems. From 1948-66 the growth rates of real profit and real compensation were 4.5% and 4.9% respectively. However, from 1966-73 real profit declined by 3.1% per year while real compensation continue to rise by 4.4% per year. This profit squeeze played a role in the demise of postwar regulated capitalism (Bowles et al., 1990).

previously since 1929. During the 1950s and 1960s the share received by the top 0.01% was between 1% and 1.5% of total income (Piketty and Saez, 2007).

In light of the financial crisis, it is not necessary to present evidence that financial institutions in the neoliberal era shifted away from their traditional activities to pursue higher-profit, more risky speculative activities. US financial institutions created trillions of dollars in risky mortgage-related and other types of securities, whose collapse is directly responsible for the financial crisis. For a time the speculative practices of the financial sector were enormously rewarding. The share of the profits of financial institutions in total corporate profits nearly doubled from 21.1% in 1979 to 41.2% in 2002, before falling to 37.2% in 2006 (U.S. Bureau of Economic Analysis, 2008, Table 1.14).

The third development in the neoliberal era is the emergence of large asset bubbles. In the first long expansion in the 1980s, an asset bubble arose in Southwestern commercial real estate, which led to the collapse of a large part of the savings and loan industry and then its bailout in 1990. In the expansion of the 1990s, starting in 1994 a huge asset bubble emerged in the US stock market. From 1994-99 the Standard and Poor's Composite Index rose at 23.6% per year while corporate profits rose at 7.6% per year (Economic Report of the President, 2001, Table B-95, p. 384; US Bureau of Economic Analysis, 2001). The following year that asset bubble collapsed. In the third long expansion of the neoliberal era, a huge asset bubble started growing in the housing sector around 2002. During 1982-95 the ratio of the Housing Price Index to the Homeowners' Equivalent Rent (the latter indicates the economic value of owning a home) moved up and down but showed no trend. In 1995 the value of that ratio was 115.0, then it rose gradually to 129.7 in 2002, followed by a steep ascent to 168.3 in 2006 (Office of Federal Housing Enterprise Oversight, 2008; U.S. Bureau of Labor Statistics, 2008). By the summer of 2007 housing prices had risen by 70% corrected for inflation since 1995. At its peak in 2007, the housing bubble created an estimated \$8 trillion in inflated new housing wealth, out of total housing wealth of \$20 trillion, or 40% of housing wealth.¹

These three developments -- growing inequality, a speculative financial sector, and a series of asset bubbles -- underlay the long economic expansions of the neoliberal era. The rapid growth of profits in the neoliberal era created a strong incentive to expand production. As the expansion continued and the unemployment rate fell, the neoliberal institutions rendered workers' bargaining power so weak that there was no risk that wages would rise to squeeze profits, making possible long expansions without either a profit squeeze or rising inflation.² However, while profits growing faster than wages may be good for the creation

1 The \$8 trillion estimate of inflated housing value in 2007 is from Baker (2007, p. 8). The estimate is based on the finding that housing prices moved largely in step with inflation from the end of World War II through 1995, followed by an increase of 70% corrected for inflation from 1995-2007. The figure of \$20 billion for the total market value of housing is for real estate owned by households at year-end 2007 (Federal Reserve System, 2008, table B.100).

2 During 1997-2000, despite the unemployment rate falling under 4.5%, the rate of growth of

of surplus value, it gives rise to a problem in the realization of surplus value. An economic expansion under neoliberal capitalism faces a problem of inadequate aggregate demand growth, since consumer spending by workers is restrained by the stagnation or decline in real wages, and the expansion of state spending is restrained by cuts in social spending and pressures from tax cuts on business and the rich. It is unlikely that accumulation and capitalist consumption can grow fast enough by themselves to generate sufficient aggregate demand growth to bring a long expansion.

This problem was solved under neoliberal capitalism in the only way possible -- by some group spending more than its income. That is, long expansions were possible through growing borrowing. Growing borrowing requires increasing collateral against which to borrow, and asset bubbles have provided that increasing collateral. In the 1990s the stock market bubble stimulated rising consumption, as upper-middle and upper income households, believing they were growing very rich as their stock portfolio values shot upward, borrowed against their rising securities wealth, causing consumer spending to rise faster than GDP in the late 1990s.¹ The 1990s expansion ended only when the stock market bubble deflated in 2000.

In the latest expansion, the neoliberal model had fully matured, producing a huge gap between the growth rates of profits and wages, as figure 3 showed. By that stage in the evolution of neoliberalism, a long expansion would be possible only if an asset bubble arose of such great proportions that it would enable a large part of the population to borrow and consume beyond its means. Although one cannot claim that it arose for that purpose, the housing bubble of the 2000s did fill that role.² A far larger proportion of the population owns housing than owns any significant value of corporate stock. Also, the total value of real estate held by the US household sector is, in normal years, much greater than the value of direct stockholdings plus mutual fund shares.³

During 2000-07 GDP grew at the rate of 2.32% per year, disposable personal income grew by 2.66% per year, while consumption grew by 2.94% per year (US Bureau of Economic Analysis, 2008). Thus, the long expansion of 2000-07 was driven by consumer spending that rose more rapidly than GDP, rising from 68.7% of GDP in 2000 to 70.3% in

output per hour, at 2.9% per year, was nearly double the rate of increase in earnings of nonsupervisory workers of 1.5% per year (U.S. Bureau of Labor Statistics, 2008). The rate of profit in the nonfinancial corporate business sector did fall in that period, but due to factors other than a wage squeeze on profits (see Kotz, 2009).

1 See Kotz (2003) for a detailed analysis of the 1990s expansion in the US. The stock market bubble also promoted a long expansion by creating optimistic expectations about future profitability, which stimulated investment demand.

2 See Kotz (2008) for an analysis of the expansion of the 2000s in the US.

3 In 1995, before housing prices began their rise and when the 1990s stock market bubble was just beginning, the value of real estate held by the household sector was 54.2% greater than the value of its stockholdings. In 1999, the peak year of the stock market bubble, the value of stockholdings of households rose to 172.8% of disposable personal income, but in the peak year of the housing bubble, 2006, the value of real estate was 235.5% of disposable personal income (Federal Reserve 2008, table B.100, and U.S. Bureau of Economic Analysis, 2008, table 2.1).

2007. How could consumption grow faster not only than GDP but than disposable income?

Figure 4 shows an estimate of "gross equity extracted" from housing, which is the funds households extracted from home equity through borrowing in the residential mortgage market. In 2002 such equity extractions leaped up to equal about 8% of disposable personal income, and from 2004-06 they were in the range of 9-10% of disposable personal income. These huge extractions from home equity, which would not have been possible in the absence of the rapid runup in home prices, represented additional spendable funds beyond households' disposable income.

While asset bubbles provided the collateral for the growing borrowing necessary to keep an economic expansion going in the neoliberal version of capitalism, the restructured financial sector provided the loans to make it possible for people to spend their growing asset wealth without having to sell the asset. After 2000 the deregulated financial sector found ways to make huge profits from making mortgage loans to a broad swath of the population including those with moderate or low incomes, through subprime mortgages, alt-A mortgages, and other new types of mortgages. Any undue risk was transferred by the issuers onto others through securitization of mortgages, with compliant security rating agencies often giving undeserved AAA ratings to such securities. Furthermore, such loans seemed safe as long as housing prices kept rising, since foreclosure would bring the creditor institution an asset that was appreciating in value. As always happens during large-scale asset bubbles, many actors became persuaded that the rising asset prices would continue indefinitely.

However, supply does not create its own demand, and the deregulated profit-seeking mortgage purveyors had to find sufficient demand for mortgage loans. The worsened economic circumstances of the majority of households during 2000-07, a product of the mature neoliberal model, created that demand. The business cycle of 2000-07 was the only one of the post-World War II period in which real median household income actually was lower at the end, in 2007, than it had been at the beginning, in 2000.¹ As millions of families struggled to keep their heads above water, it was easy to entice many of them into borrowing against their home, often at a low initial rate, which appeared as the only way to pay their bills. A majority of the subprime mortgage loans in this period were for refinancing rather than the purchase of a new residence.

Some have criticized former Fed Chairman Alan Greenspan for failing to use the tools available to him to stop the housing bubble in the early 2000s. His reluctance to act may have stemmed from his free-market attitude toward the financial sector. However, within the logic of neoliberal capitalism there were good reasons for his inaction, and indeed for his promotion of the housing bubble through easy monetary policy. Easy monetary policy and the start of the housing bubble were responsible for avoiding a severe recession

¹ Real median household income fell from \$50,557 to \$50,233 from 2000-07 in 2007 dollars (U.S. Census Bureau, 2008, table H-6).

following the collapse of the stock market bubble in 2000 (Kotz, 2008). Stoking the housing bubble may have appeared to be the only feasible way to promote growth of output and profits in the early 2000s, within the strictures of the neoliberal model.

3. Crisis

Over the whole period of neoliberal capitalism in the US, the series of long expansions gave rise to unsustainable trends. Each long expansion further increased the indebtedness of households. Figure 5 shows household debt as a percentage of disposable personal income from 1980-2007. That percentage rose from 59.0% in 1982 to 77.5% in 1990 and 91.1% in 2000, before ballooning to 128.8% in 2007. This trajectory had become unsustainable by the end of the 2001-07 expansion. A system in which wages are suppressed so severely that economic expansion is possible only through growing household debt cannot continue indefinitely.

Not only did the financial pressure on households increase over time, the level of fragility of the financial sector grew over time. As financial institutions sought ever higher profits through ever more opaque and risky activities, the threat posed by an asset bubble deflation grew. While the financial system weathered the deflation of the stock market bubble in 2000-2001, it grew still more fragile in the following expansion. As trillions of dollars in risky mortgage-related securities spread through the U.S. financial system, and into much of the global financial system, in the mid 2000s, the financial system became ever more vulnerable to a deflation of the housing bubble.

Finally, like a heroin addict needing bigger and bigger doses, the system required asset bubbles of growing size and reach for each new expansion, if a new long expansion were to be viable. The impact of the savings and loan collapse on the system as a whole was modest. The impact of the deflation of the larger stock market bubble of the 1990s was much bigger, but it was possible to contain it. However, the housing bubble of the 2000s was massive, and the impact of its eventual deflation would accordingly be huge.

The upward resetting of the rates on a rapidly growing volume of variable rate mortgages in 2006-07 played a role in reversing the growth of the housing bubble in 2007. However, identifying the specific cause of the end of the housing bubble is not of central importance here. As is the case with all asset bubbles, the housing bubble of the 2000s was bound to deflate at some point. Once the housing bubble began to deflate, all of the foregoing trends would become unsustainable. The deflation of the housing bubble would take down a large number of households who could no longer make payments on their existing loans and could no longer refinance to make their payments manageable. The increasingly fragile financial sector could not survive the deflation of the housing bubble. The massive size of the housing bubble, so necessary for the third installment of economic

expansion in the 2000s under the neoliberal model, assured that its collapse would bring the neoliberal era to a close.

It is common to view the severity of the current recession in the real sector as a consequence of the financial crisis. However, the real sector recession, while made worse by financial crisis, is driven by the same development that led to the financial crisis -- the deflation of the housing bubble. A possible \$8 trillion decline in housing wealth, as the bubble deflates, is bound to cause a steep decline in consumer spending, which began in the third quarter of 2008.¹ The steep decline in consumer spending is bound to cause a sharp decline in business fixed investment. Since the housing bubble is likely to take several years to fully deflate, this process will continue for some time. The financial crisis makes the real recession worse, but even if the financial system were quickly fixed and began to offer credit to the real sector, one would not anticipate much demand for credit in the face of the powerful downward forces acting on the real sector from the housing bubble deflation.

The evidence suggests that we are seeing more than just a severe financial crisis and a severe recession. We are witnessing a crisis of the neoliberal form of capitalism. The ability of that form of capitalism to promote expansion of output and profits appears to have reached its end. Another expansion, within the existing neoliberal model, would require a new asset bubble even more massive than the housing bubble, and it is difficult to imagine how this could arise. Further, the deregulated financial system of the neoliberal model, which would have to play a key role in any new asset bubble, has been unable to survive the collapse of the latest one. Most of the major US financial institutions have needed large government bailouts, and the assets of the financial sector are undergoing a massive contraction. It is difficult to imagine the neoliberal model surviving intact at this time.

4. Possible Directions of Restructuring

History suggests that the US economy, and also the global economy, will undergo restructuring in the coming period. History also suggests that the next economic structure will involve a significant expansion of the state role in the economy. However, history cannot tell us what kind of state regulated economic system will arise. The outcome will depend on political struggles among various groups and classes. One can identify three possible types of state regulated system that might arise in the US in the coming years.

The first is a corporatist form of capitalism. At present the main actors maneuvering to

¹ Consumer spending fell at the annual rate of 3.7% in the third quarter of 2008 (U.S Bureau of Economic Analysis, table 1.1.1, revision of November 25). Estimates of the wealth effect on consumption are in the 4-6% range, which suggests that a full deflation of the estimated \$8 trillion housing bubble could by itself reduce consumer spending by \$320 billion to \$480 billion, a decline of up to 4.7%.

control the direction of economic restructuring appear to be the big banks and nonfinancial corporations. Popular movements are relatively weak at this time in the US, following nearly 30 years of neoliberalism. If popular movements remain weak and are not able to have a significant impact on the process of restructuring, then big business will determine the course of restructuring. It seems likely that, in that case, a corporatist form of capitalism would emerge. By this is meant a form of capitalism in which big business regulates the economy through the state, in ways that will restore the stability and profitability of capitalism and permit accumulation to resume over a long period of time.

A corporatist form of capitalism in the U.S. might have the following main features. First, the financial system would become subject to regulation by the state to ensure its stability and the resumption of its necessary functions in support of the real sector. The exact nature of a new financial structure would depend on the relative strength of financial and real sector capital. Second, the institutions directly affecting the capital-labor relation would remain similar to those of neoliberalism, to assure a high rate of profit. Capital would remain fully dominant over labor.¹ To resolve the aggregate demand problem arising from repressed wage growth, the third feature would be a large, long-lasting program of state investment in areas that would promote profit-making. A more "progressive" version would emphasize state infrastructure investment in transportation, communication, power, and technological development. A more "reactionary" version would emphasize military and national security spending. Some combination of the two would also be possible.²

Such a corporatist restructuring could provide a coherent new SSA. Low wages would assure a high profit share. A regulated financial system would assure financial stability and provide credit to the real sector. The state would solve the aggregate demand problem, resulting from rapidly rising profit and stagnating wages, through expanding state spending. Such a form of restructuring would not be favorable for working people. History suggests that a form of capitalism more favorable to the working class emerges only in the face of a militant and radical popular movement, which forces big business to compromise. Such popular movements played a key role in the Progressive Era, and in the creation of the state regulated postwar system whose roots were in the New Deal period starting in the mid 1930s. While a new liberal form of capitalism can be built relatively rapidly, constructing a new state regulated form of capitalism takes some time. Even if capital initially dominates the process, it takes many years for the various segments of capital to reach agreement and to design a coherent program for the state to effectively both regulate and stimulate the

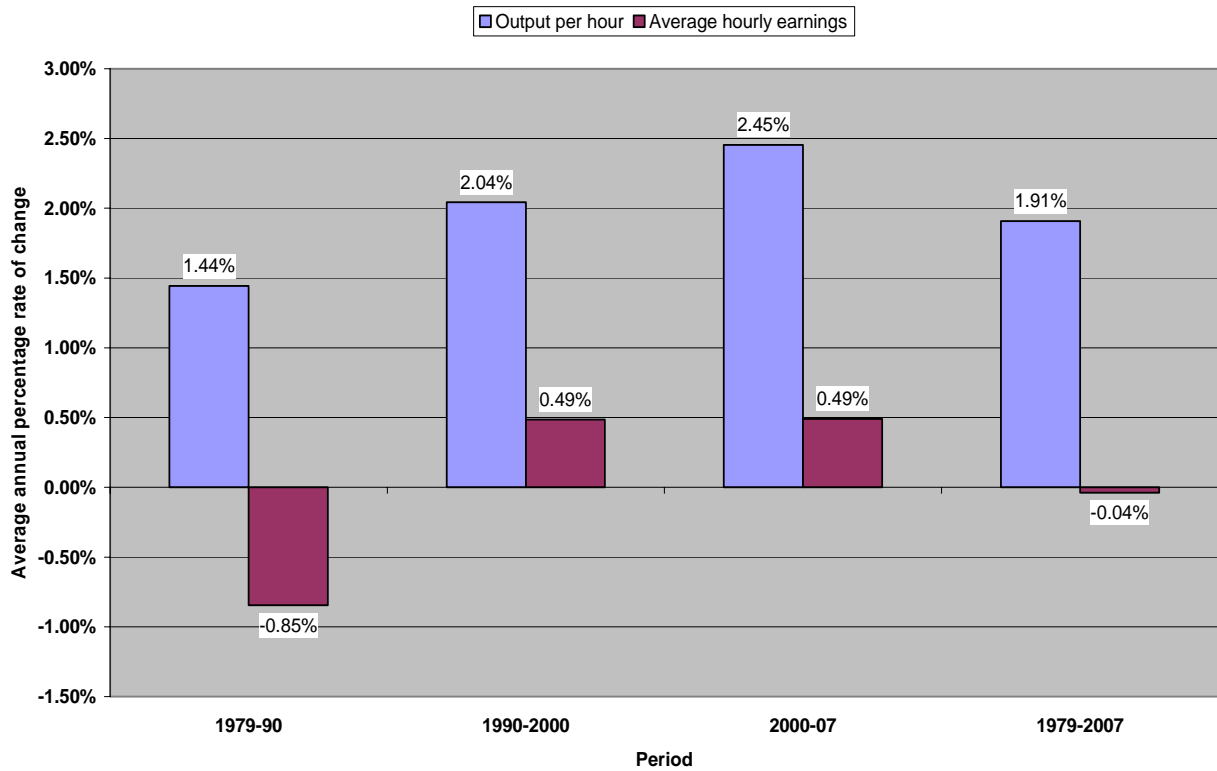
1 The many calls from conservative commentators to use the proposed auto industry bailout to crush the United Auto Workers Union and drive down wages in that industry is consistent with a corporatist restructuring.

2 This may explain the recently expressed enthusiasm for a big infrastructure investment program among some conservative policy analysts. Conservative advocate William Kristol recently proposed "spending a good chunk of the [expected large government] stimulus on national security" rather than civilian infrastructure (Kristol, 2008).

economy. If the economic crisis is as severe as most expect, this may lead to the emergence of strong popular movements, which would affect the direction of economic restructuring.

If strong popular movements emerge, that might lead to a second type of state regulated capitalism involving a new social democratic compromise between capital on the one hand and labor and other popular constituencies on the other. This would require changes in the institutions that affect the capital-labor relation so as to enable workers to increase their wages in step with productivity growth. At the minimum, this would require a stronger trade union movement, a willingness on the part of big business to bargain with labor, and a shift in the form of intercapitalist competition to hold off the severe downward pressure on wages that results from unrestrained competition, as well as changes in institutions at the global level. Under those conditions, a relatively balanced growth of aggregate demand becomes possible. Expanding state spending would also play a role, involving social spending and environmental spending, as well as infrastructure investment. As in the corporatist version, the financial sector would be closely regulated. The third possibility would be the replacement of capitalism with socialism. For nearly 30 years neoliberal capitalism has worsened conditions for the majority in the US and around the world. Now the severe financial and economic crisis is showing capitalism at its worst, as the profit motive completely fails to meet people's needs for a decent living standard including both private and public goods and services, meaningful work, economic security, and an economy that is environmentally sustainable. As people struggle against the threatened loss of their homes, unemployment and the associated loss of health insurance, the disappearance of much of their life savings, and the growing threat of global climate change, the arguments for a socialist alternative can potentially ring true for millions of people. The socialist movement may be reborn in the years ahead, opening the possibility of finally ending the capitalist era.

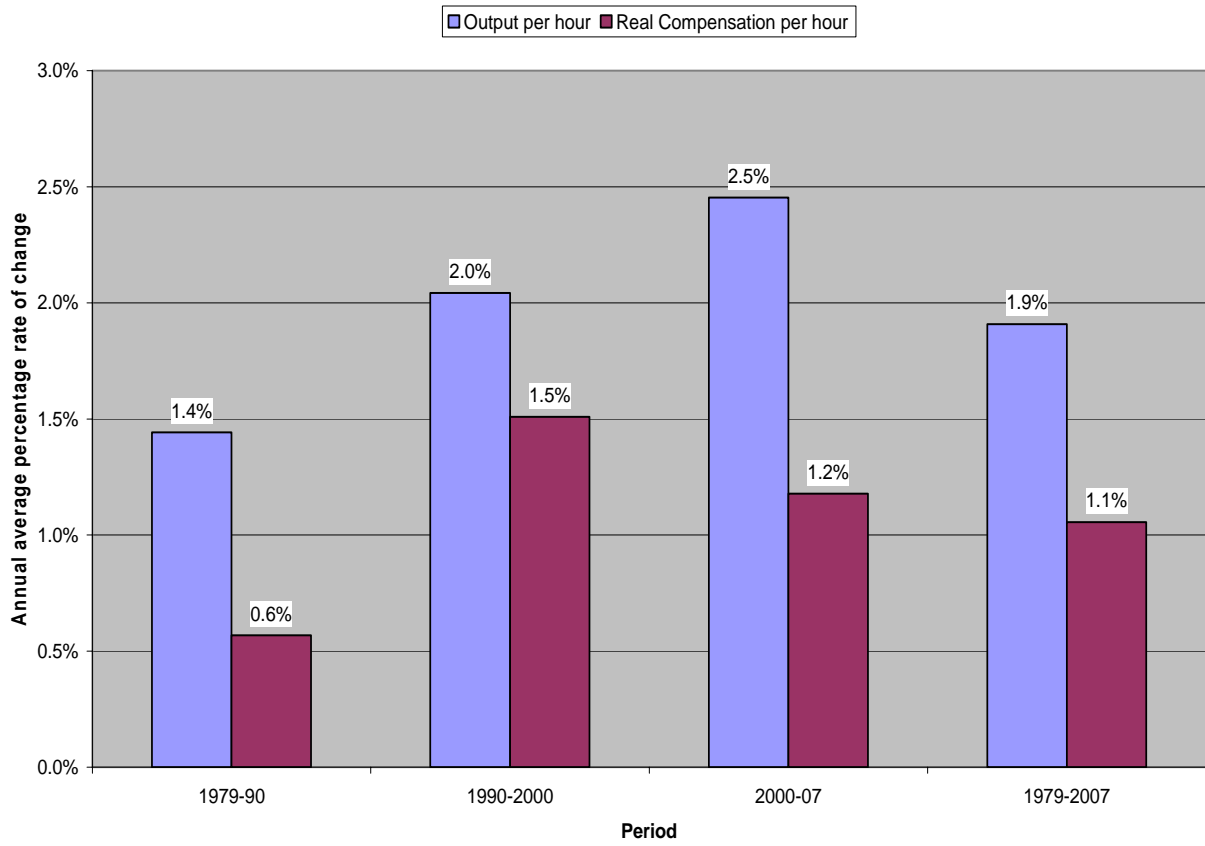
Figure 1. Growth Rates of Output per Hour and Real Average Hourly Earnings of Nonsupervisory Workers



Note: Data are for the nonagricultural private sector.

Source: U.S. Bureau of Labor Statistics, 2008.

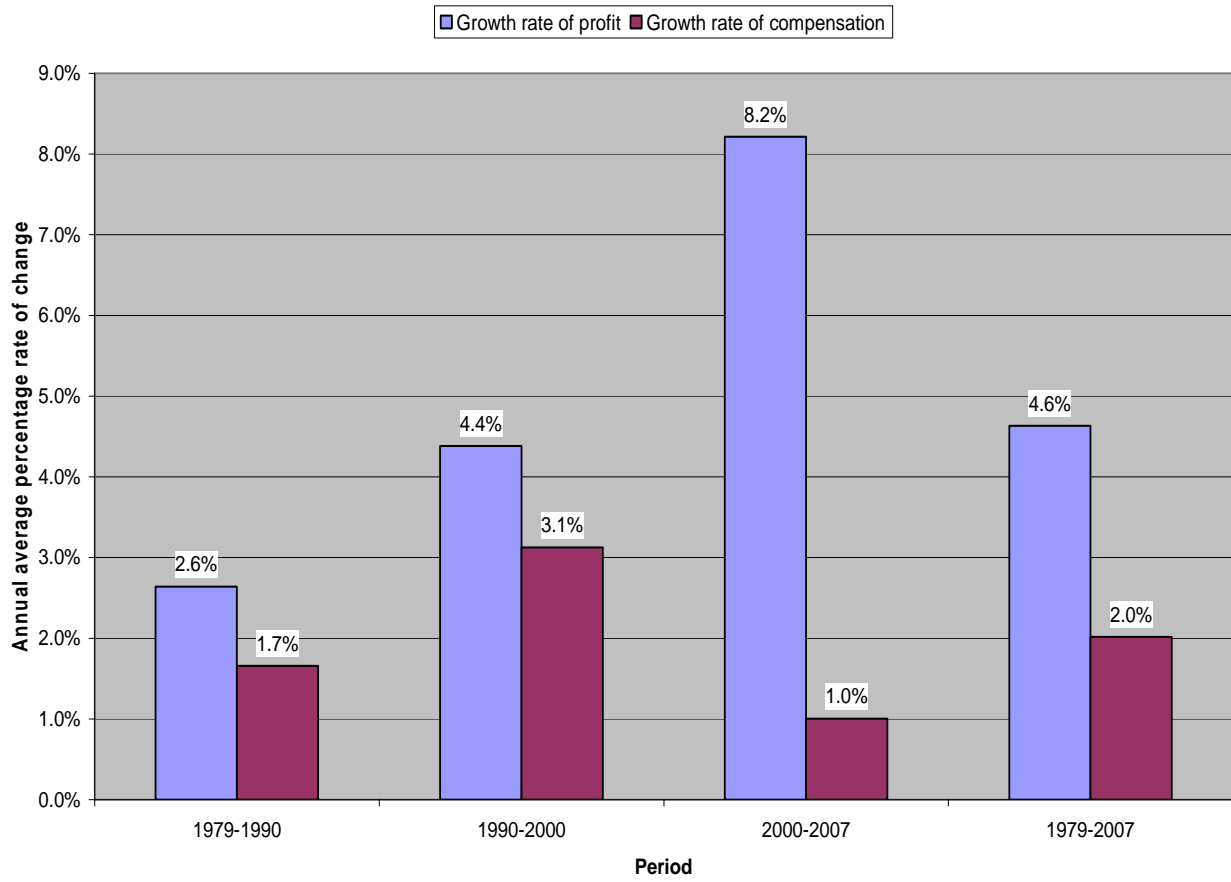
Figure 2. Growth Rates in Output Per Hour and Real Compensation per Hour



Note: Data are for the nonfarm business sector and cover all employees in that sector.

Source: U.S. Bureau of Labor Statistics, 2008.

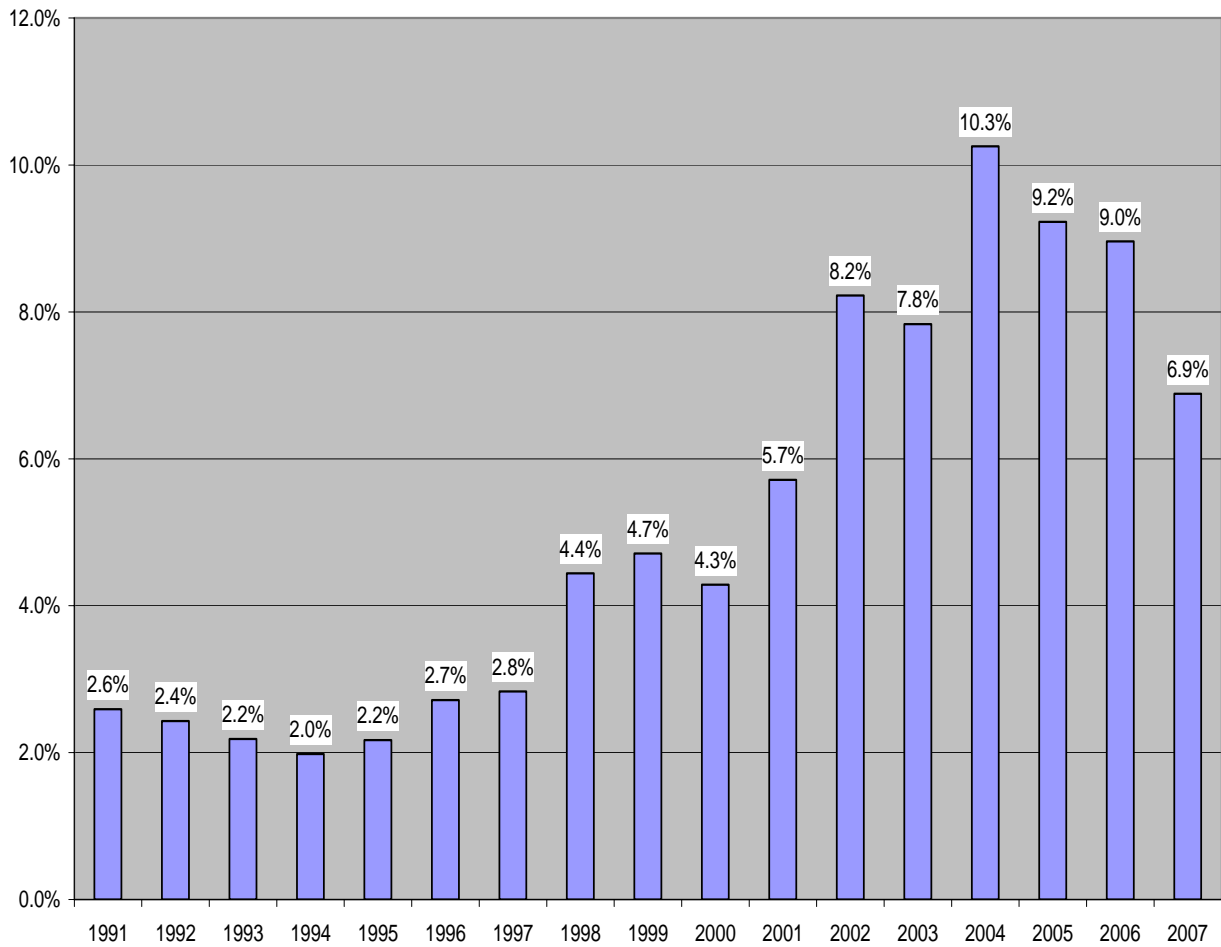
Figure 3. Growth Rates of Profit and Compensation



Note: Data are for the corporate business sector. Profit is after tax and deflated by the GDP price deflator. Compensation is deflated by the consumer price index.

Source: U.S. Bureau of Economic Analysis, 2008, table 1.14 and 1.1.4; U.S. Bureau of Economic analysis, 2008.

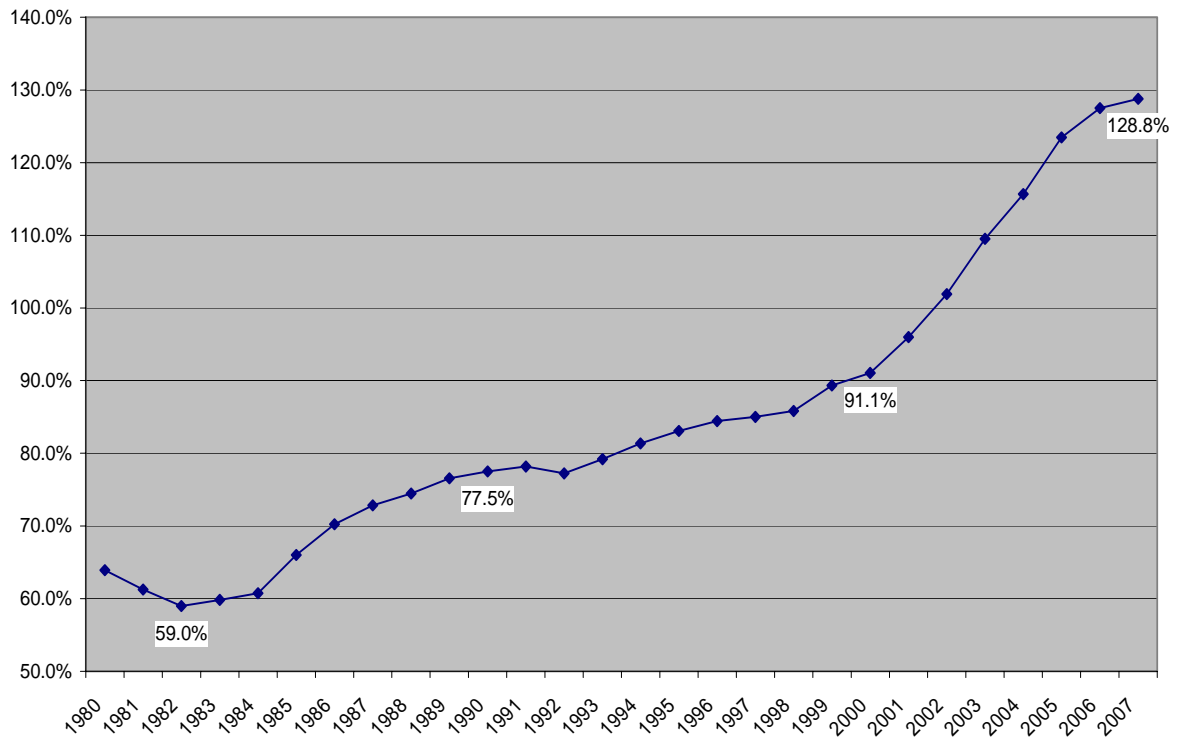
Figure 4. Gross Equity Extracted as a Percentage of Disposable Personal Income



Note: For 2007, the average of the first three calendar quarters.

Source: Updated data from Greenspan and Kennedy (2007) The updated data are from the Federal Reserve, obtained by Steven Fazzari.

Figure 5. Household debt as a Percentage of Disposable Personal Income



Note: Household debt is the sum of mortgage debt and credit card debt.

Source: U.S. Bureau of Economic Analysis, 2008, table 2.1; Federal Reserve System, 2008, table B.100.

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