

# **Neoliberalism and the US Economic Expansion of the 1990s**

by David Kotz

Economics Department and Political Economy Research Institute  
Thompson Hall  
University of Massachusetts  
Amherst, MA 01003  
U.S.A.

Telephone 413-545-0739  
Fax 413-545-2921  
E-mail [dmkotz@econs.umass.edu](mailto:dmkotz@econs.umass.edu)

January, 2003

This paper was published in *Monthly Review*, Volume 54, Number 11, April 2003, pp. 15-33. A longer version of this paper is available as "The U.S. Economy in the 1990s: A Neoliberal Success Story?," 2002. Research funding was provided by the Political Economy Research Institute at the University of Massachusetts at Amherst. Research assistance was provided by Ozgur Orhangazi, Zhu Andong, and Wu Jing.

The US economy has been undergoing a profound restructuring during the past two decades. This process, known as neoliberal restructuring, has affected practically every dimension of social life, including the gap between rich and poor, the nature of work, the role of big money in politics, the quantity and quality of public services, and the character of family life.

Neoliberal restructuring centers on the role of the state in the economy. It has entailed renouncing the use of government spending and taxing to moderate the ups and downs of the business cycle; loosening or eliminating government regulation of corporate behavior in both the domestic and international spheres; privatization of government enterprises and public responsibilities; and large cutbacks in social programs. This restructuring has come to be called "neoliberal" because it is an updated, and more extreme, version of the "classical liberal" economic theory developed in the eighteenth and nineteenth centuries by Adam Smith and David Ricardo, who argued that a capitalist economy is largely self-regulating through the action of market forces.

The revival of a version of classical liberal thought came as a surprise, since it had been discredited and lost its dominant position following the Great Depression and World War II. Fearing a return of the Depression, and facing large and growing socialist and communist movements in many parts of the world, after World War II the ruling classes in the US, Britain, and other leading capitalist countries reluctantly accepted a raft of social welfare programs and a more activist state role in regulating the capitalist economy. For reasons that we cannot go into here, starting in the late 1970s this Keynesian regulationist approach, which had been dominant for some twenty-five years following World War II, was gradually abandoned, replaced by a new version of classical liberalism, with Britain and the US leading the way.

Contemporary neoliberalism has become fully dominant among mainstream thinkers in the US and Britain. This new conventional wisdom holds that the many economic and social problems of the decades following World War II resulted from government meddling in the economy. The rediscovered "free market economy" is, we are told, the route to optimum efficiency, rapid economic growth and innovation, and rising prosperity for all who are willing to work hard and take advantage of available opportunities.

The US has sought to redesign the institutions of the international capitalist economy to conform to neoliberal prescriptions, while also demanding neoliberal restructuring within countries in Western and Eastern Europe, Asia, Africa, and Latin America. In many countries the elites have welcomed such changes. However, change has been slow in some countries due to popular support for social welfare programs and state regulations that are intended to provide some protection against the enormous inequalities and instabilities generated by a capitalist economy.

One hindrance to the US ruling class agenda of creating a neoliberal world system has been the glaring absence of convincing evidence that neoliberal restructuring produces the benefits claimed by its promoters. There were many social and economic problems in the regulated capitalism that predominated in the quarter-century immediately following World War II, as is always the case in a capitalist system. However, economic historians agree that the overall economic performance of the leading capitalist countries during those 25 years was the best ever achieved by them. For that reason, the period from roughly 1950 to 1973 is often called the "Golden Age" of capitalism. Table 1 shows growth rates in real gross domestic product per capita, which measures the output of goods and services in the economy, per person in the population, since the early 19<sup>th</sup> century. Economic growth was much faster during 1950-73 than in any period before or since.

The period 1973 through the early 1990s was a time of slow growth and great economic and financial instability in the industrialized capitalist countries. The US and Britain, which led the shift to neoliberal restructuring, showed poor economic performance by conventional measures during that period. The countries that undertook the most thorough neoliberal restructuring -- the formerly Communist Party ruled states in Eastern and Central Europe -- suffered disastrous economic decline. Meanwhile, the fastest rates of economic growth and development among capitalist countries during that period were found in regimes that departed significantly from the neoliberal model, such as Japan and South Korea, which which had strongly state-guided economies. By the early 1990s, neoliberal advocates found themselves increasingly on the defensive.

In the 1990s the leading state-guided capitalist success stories ran into serious difficulties. Japan entered a decade of stagnation at the start of the 1990s. In 1997 a financial crisis struck South Korea and the other Asian "tigers," ending their rapid growth and placing them under the thumb of the US Treasury Department. Neoliberal restructuring has been more or less successfully imposed on South Korea, with support from its own business elite, while Japan is under strong pressure from without and within to abandon its state-guided version of capitalism.

However, negative examples only carry so much weight. The advocates of neoliberalism desperately needed a positive example of neoliberal restructuring that produced the promised benefits in a major country. In the second half of the 1990s, neoliberalism claimed to find its long-awaited success story, right in the main source of neoliberalism: the US.

The US government has followed neoliberal policies, with varying consistency over time, since the second half of the Carter Administration in the late 1970s. Despite Bill Clinton's relatively interventionist rhetoric during the 1992 presidential campaign, upon taking office his administration hewed closely to the neoliberal agenda of cutting government spending, pursuing free trade agreements, and generally seeking to free market forces from government regulation.<sup>1</sup>

Following several years of sluggish recovery from the 1990-91 recession, after 1995 the growth rate of real gross domestic product (GDP) in the US shot up above 4% per year. Relatively rapid growth continued through 2000, and the official unemployment rate fell to 4 percent by the end of the decade, while inflation remained subdued. The expansion surpassed that of the 1960s as the longest continuous US expansion on record. From 1995 to 1999 stock prices rose at the astronomical rate of 24 percent per year, fattening the portfolios of the rich while creating an appearance of new-found wealth among some middle-income strata. The pundits proclaimed that the benefits of neoliberal restructuring had finally been demonstrated. Some even argued that recessions and stock market crashes were now a thing of the past, with the future holding the promise of permanent, inflation-free growth in the economy and an endlessly rising stock market.

The stock market collapse after August 2000 and the recession that followed in the spring

---

<sup>1</sup> See Robert Pollin, "Anatomy of Clintonomics," *New Left Review*, 2<sup>nd</sup> Series, No. 3, May/June, 2000, 17-46.

of 2001 punctured the rosy picture of a capitalist nirvana. However, a strong belief remains, in many places in the world, that US economic performance in the 1990s conclusively demonstrated that neoliberal restructuring is the way to build an effective capitalist economy. Even the most benign forms of capitalism are unable to meet the needs of the majority, but the US economic record in the 1990s shows that, far from being a superior mode of capitalist organization, the neoliberal version, even at its "best," has failed to live up to the predictions of its promoters.

Neoliberal restructuring did contribute to a certain kind of recovery from the 1990-91 recession and did foster an unusually long expansion, with low inflation despite historically low unemployment. However, the processes by which neoliberal policies contributed to these outcomes were different from the official story. The neoliberal regime produced an economic expansion in the US in the 1990s that was highly unstable, generated growing imbalances in the economy, and mainly benefitted those at the top of the income pyramid, even more so than in the typical capitalist economic expansion. While every expansion in a capitalist economy eventually ends in recession, the character of the expansion of the 1990s planted seeds of particularly severe problems ahead.

### **The 1990s Expansion Compared to Previous Expansions**

Official data show that the economic expansion of 1991-2000, despite its longevity, does not rank high by the usual measures of economic performance. Table 2 compares the expansion of 1991-2000 to the five previous expansions. It uses two conventional measures of economic performance, the average rates of growth of GDP and of labor productivity. The labor productivity measure is highly problematic, since it attempts to measure physical output per worker for the entire nonfinancial economy. Measuring physical output poses severe conceptual difficulties outside of the manufacturing sector. However, since the official labor productivity data are widely cited by establishment sources as an indicator of economic performance, they are included in table 2.

Based on GDP growth, the 1990s ranks second to last among the six expansions. Only the brief and anemic expansion of 1980-81 had slower GDP growth than the 1990s. Measured by the problematic labor productivity growth indicator, the 1990s look better, ranking above the three

preceding expansions but still falling far short of the rapid productivity growth of the 1960s and early 1970s.

The 1990s look better with respect to unemployment and inflation. The official unemployment rate fell to 4.0% in 2000, which was the lowest since the 1960s. The inflation rate at the end of 1990s expansion was the lowest of any of the six expansions. The 1990s expansion lasted an even ten years, compared to the 8 years 10 months of the next-longest expansion in the 1960s. While the unemployment rate remained stubbornly high for the first three years of the expansion, the long duration of the expansion eventually drove unemployment below 5 percent.

Economic performance improved markedly in the second half of the 1990s expansion. After 1995 GDP growth averaged 4.1 percent per year, an increase of one-third over the 1991-95 rate, and labor productivity rose at 2.5 percent, an increase of more than one-half compared to the 1991-95 rate. The marked acceleration in output and productivity growth in the later part of an expansion is not typical.

After 1995 some commentators painted an increasingly rosy picture of the expansion. Comparing the "best" part of one business cycle expansion to the entire period of other expansions is not a valid way to judge an expansion, but even such a comparison does not significantly change the ranking of the 1990s expansion. In GDP growth the period 1995-2000 barely edges out the 1980s expansion, moving up from 5<sup>th</sup> to 4<sup>th</sup> place, while productivity performance still failed to come close to that of the 1960s and early 1970s, leaving the productivity ranking unchanged.

### **Features of the Expansion**

The expansion of 1991-2000 had two distinct phases. During 1991-1995 there was a sluggish and lengthy recovery from the 1990-91 recession. After 1995 economic growth accelerated, driven first by an investment boom and, after 1997, by a remarkable consumption boom. By analyzing these two phases of the expansion, it is possible to uncover the underlying forces that drove the 1990s expansion and also see the fundamentally unstable character of the process.

Total demand for goods and services is a key determinant of growth in a capitalist

economy. Total demand consists of consumer spending by households, investment spending by business firms, government spending, and any excess of exports over imports. In the US economy, the largest and most important components of demand are consumer spending, business fixed investment (spending for new equipment and structures), and government spending.<sup>2</sup> It is the growth of those three components of total demand that is mainly responsible for growth in the economy as a whole.

During 1991-95 GDP grew at the modest rate of 3.1 percent per year. The recovery from the previous recession was led by business fixed investment, which grew at the rapid rate of 7.6 percent per year. Consumer spending rose by 3.2 percent per year, about the same rate as GDP, neither leading the recovery nor slowing it down. No stimulus came from government, since government spending was practically stagnant (at 0.1 percent growth per year). The modest investment boom of the early 1990s was not strong enough to bring rapid growth in the economy as a whole, given the stagnation of the large government sector.

During 1995-2000 GDP growth accelerated, rising from 3.1 percent to 4.1 percent per year. At first the sole driving force was a further increase in the growth rate of business fixed investment, which rose from 7.6 percent per year in 1991-95 to the historically very high rate of 10.6 percent per year in 1995-2000. Government spending remained sluggish during 1995-2000, growing at 2.3 percent per year, and a huge excess of imports over exports acted as a drag on economic growth after 1997.

However, after 1997 a second driving force emerged in addition to business fixed investment, when consumer spending growth suddenly accelerated. Consumer spending, forsaking its traditional position as a relatively passive factor in business cycle expansions, began growing at 4.9 percent per year in 1997-2000. Consumer spending now became the chief force propelling GDP growth, since it represents about two-thirds of GDP and it now was growing substantially faster than the GDP. Thus, to explain the faster economic growth of the second half of the 1990s, it is necessary to account for the accelerating investment boom of the decade and

---

<sup>2</sup> The remaining three components -- residential investment, increases in inventories, and the difference between exports and imports -- play some role in economic growth but are much smaller than the three demand components cited above.

three-year-long spurt in consumer spending at the end of the decade.

### **The Investment Boom**

Capitalism has a powerful accumulation drive, as capitalists seek to increase their profits by expanding the scale of operations, and as competition puts pressure on each capitalist to expand or die. However, the rate of accumulation, or investment, in the system as a whole varies significantly over time, under the impact of various factors. Many of those factors, including the trend in costs of production and in the demand for output, have a direct impact on the rate of profit firms receive on their capital. Hence, one key variable affecting the strength of capitalists' incentive to invest, which Marxist economists have always emphasized, is the rate of profit in the economy. A rising rate of profit stimulates a high rate of investment, while a falling rate of profit tends to reduce investment.

However, the simple generalization that the rate of profit has an important impact on investment is far from the whole story. For one thing, the rate of profit for the nonfinancial business sector is an average of the profit rates of many different industries, each of which may have a different trend from the average. Second, there are severe measurement and conceptual problems with the official data available to construct a measure of the rate of profit. Finally, the rate of profit records events, such as cost and sales conditions, after they are past, while investment decisions are always based on capitalists' expectations about the future. These limitations on the rate of profit mean that it should be taken as only a rough indicator of the incentive of capitalists as a whole to invest.

In addition to the rate of profit and the past cost and sales conditions on which it is based, a second key factor is the appearance of new cost-saving technologies. If a new cost-saving technology becomes available in a single industry, this can stimulate a high rate of investment regardless of the current rate of profit in that industry. In a period when a set of related cost-saving technologies appears which can be widely used across the economy, this can produce a large wave of investment.

Both of the above two factors played a role in causing the investment boom of the 1990s in the US. That decade experienced a marked long-term rise in the average rate of profit and it

also saw a revolution in information technology (IT) associated with computers and related information processing and communication equipment.

First, consider the rate of profit. As many studies have shown, the rate of profit in the nonfinancial business sector of the US economy rose to a post World War II peak in the mid 1960s, followed by a marked long-term decline lasting through the late 1980s. Starting in 1992 the profit rate rose rapidly, reaching a peak in 1996, then declining through 2000. At its peak in 1996, the rate of profit was 39 percent higher than the highest previous post-1960s peak in 1972, reaching 84 percent of the 1965 level.<sup>3</sup> By 2000, after 4 years of decline, the rate of profit was still above its average in the 1980s.

What explains the long-term rise in the rate of profit in the first half of the 1990s, compared to its level in the preceding two decades? Advocates of neoliberal restructuring argue that such restructuring promotes growth and prosperity by freeing business from excessive state control, bringing rapid increases in efficiency and productivity that will not only increase profits for business but also raise wages for workers and tax revenues for the public sector. However, an analysis of the long-term rise in the rate of profit does not fit that picture.

The value of output produced per hour worked in the nonfinancial business sector grew at the historically low rate of only 1.3 percent per year between 1972, the previous high point in the rate of profit following the late 1960s decline, and 1996, when the rate of profit reached its 1990s high. However, over those 24 years, that produced a 36.4% rise in the value of output per labor hour. Far from sharing in the productivity increase, workers found their real wages declining by 2.5 percent over the whole period. The net result was a large boost to profits.

It was the historical reversal, after 1973, of the long post-World War II trend of rising real wages, and its replacement by a trend of declining wages, that is the main factor accounting for the long-term rise in the rate of profit in the 1990s. Neoliberal restructuring between the late 1970s and the 1990s can indeed claim credit for this. The neoliberal regime reduced the bargaining power of workers in a variety of ways – through such channels as legal and political

---

<sup>3</sup> The profit rate figures are for the rate of profit on net worth, after taxes, for the nonfinancial corporate business sector, calculated from data from the Federal Reserve Flow of Funds Accounts, Tables B.102 and F. 102, 2001.

attacks on trade unions, deregulation of business, and lower barriers to international trade and investment. This is not the aspect of neoliberalism that its advocates advertise, but it was effective at raising the rate of profit.

While falling wages in the face of slow, but positive, increase in the value of output per labor hour was the largest factor accounting for the long-term rise in the rate of profit, a second significant factor was a decline in taxation of capital over the period.<sup>4</sup> This second factor was also a result of neoliberal restructuring, which entailed shifting the tax burden from capital to labor. Neoliberalism raised profits, not along with wages and tax revenues as had been promised, but at the expense of wages and tax revenues.

Marxist economists have long argued that a rise in the rate profit which results from driving wages down has a contradictory effect on the rate of capital accumulation. On the one hand, a rising rate of profit tends to stimulate investment and expansion by capitalists. However, declining wages tend to create a problem of insufficient demand for output, setting the stage for a crisis of overproduction. We shall see how this contradiction was temporarily overcome in the 1990s, producing a period of relatively rapid growth but on an increasingly precarious foundation.

The long-term rise in the profit rate in the early to mid 1990s is one factor that can explain the investment boom of the 1990s, at least in the first half of that decade. The second important cause is found in the technological revolution in IT that developed in that decade. Table 3 shows the movement of three kinds of investment that together make up business fixed investment: investment in information processing equipment and software, investment in other types of equipment, and investment in structures such as factories, stores, and office buildings.

Non-IT equipment investment grew rapidly (8.4 percent per year) in the first half of the 1990s as the profit rate rose rapidly, but it grew more slowly in 1995-2000 as the rate profit rate declined after 1996. Investment in structures, which tends to lag in upswings as firms first use their existing plant more fully, did not grow until the second half of the decade.

However, IT investment grew at the remarkably rapid rate of 14.2 percent per year in the

---

<sup>4</sup> Declining taxation on capital contributed about 40 percent as much to the rise in the rate of profit as did the decline in the real wage in the face of rising labor productivity.

first half of the 1990s and, despite the decline in the profit rate, accelerated to 20.2 percent per year in 1995-2000.<sup>5</sup> The IT revolution made available new equipment each year that promised big cost savings and other benefits to business. A competitive dynamic caused business to fear that failure to continually upgrade with the latest IT equipment would spell their doom. At the middle of the decade, IT investment was 40 percent of all equipment investment, so the rapidly growing IT investment was a major factor in the investment boom of the 1990s.

The accelerating rate of investment in 1995-2000 was entirely due to accelerating investment in IT. The extremely high rate of IT investment growth in that period, together with the appearance of huge excess capacity in much of the IT sector after the boom ended, strongly suggest that, while technological changes are part of the explanation for the IT investment boom, it was vastly overdone. The underlying explanation for the two factors which caused the accelerated economic growth during 1995-2000 -- both the excessive IT investment of the late 1990s and the spurt of consumer spending after 1997 -- is found in a single development: the great speculative bubble that arose on the US stock market in the mid 1990s.

### **The Great Speculative Bubble**

Prices on the US stock market rose gradually in the early 1990s. Then in 1995 they took off. Figure 1 shows this dramatic shift in stock price behavior, using the broad Standard and Poors Composite Index of common stock prices for 500 large corporations. As figure 1 shows, during 1990-94 stock prices grew at close to the same rate as corporate profits. This is a normal relationship, since stock ownership confers the right to receive the dividends a corporation pays out of its profits. GDP grew somewhat more slowly than corporate profits, which reflects the shift in income from wages and salaries to profits during the 1990s.<sup>6</sup>

Starting in January of 1995, stock prices began rising rapidly. The great 1990s stock market bubble had begun. As figure 1 shows, stock prices rose at the phenomenal annual rate of

---

<sup>5</sup> The peculiarities of the method used by the Government's Bureau of Economic Analysis to compute the price index for computers may substantially overstate the growth rate of "real" (inflation-corrected) IT investment. The current dollar figures for IT investment show an annual increase of 9.6 percent per year in 1991-95 and 12.2 percent in 1995-2000. The pattern is the same but the growth rates appear less stratospheric by this measure.

<sup>6</sup> To be comparable to stock price changes, the GDP growth rates in figure 1 are not corrected for inflation. Hence, they differ from the GDP growth rates shown in tables 1 and 2.

23.6 percent for the next five years. During that period corporate profit growth actually slowed down. The S&P Composite Index hit its peak in August 2000 and then began a descent that lasted, with some ups and downs, through the time of this writing. Given the total disjuncture between stock price and corporate profit movements during 1994-99, the growth in stock prices during that period was clearly driven by speculative factors – that is, by the belief that share prices would continue to rise rapidly and hence would provide large capital gains for shareholders.

The financial bubble of 1994-99 was massive in scale. The aggregate market value of the outstanding shares of US corporations rose from \$5.5 trillion in 1994 to \$17.1 trillion in 1999, an increase of \$11.6 trillion.<sup>7</sup> By comparison, the entire GDP was \$9.9 trillion in 2000. The price-earnings ratio for stocks in the S&P Composite Index rose from 19.9 at year-end 1994 to 44.2 at year-end 1999. If one takes a price-earnings ratio of 20 as a long-term normal ratio, then about \$9.4 trillion of the \$11.6 trillion rise in equity values during 1994-99, or 81 percent, may have represented a speculative increase.

Several factors contributed to the emergence of the massive speculative bubble of 1994-99, but the most important of them derived from the neoliberal model. The rapid increase in the rate of profit in 1991-96, which, as we noted above, reached a level not seen since the 1960s, created a strong incentive to invest in US corporate securities. In addition, the rise in the share of income going to profits, and more generally the dramatic increase in income inequality, that had been going on since the late 1970s, placed a growing proportion of income in the hands of those at the upper reaches of the US income pyramid. Those groups typically save the bulk of their income, and this process produced a growing volume of both institutional and personal investable funds seeking an outlet, much of which poured into stock purchases. Both of these factors derive ultimately from the neoliberal restructuring process, which set the stage for a speculative bubble, just as a decade of neoliberal restructuring did so in the 1920s.

A third factor was that a string of severe economic crises outside the US in the 1990s caused a growing volume of foreign capital to flee to the US, and also caused US funds

---

<sup>7</sup> Flow of Funds Accounts, 9/18/01, Table L.213, line 19.

previously invested abroad to seek safety in the US. Specifically, the Asian financial crisis of 1997 caused what had been a huge inflow of funds into the rapidly growing East Asian economies to suddenly turn into an even more rapid outflow. The following year, the Russian financial crisis of 1998 created a general investor fear of so-called "emerging markets." This one-two punch sent a large volume of funds flowing into the US stock market, prolonging the bubble.<sup>8</sup> Neoliberalism can claim a sort of back-handed credit for this, in that it was liberalization of the East Asian economies that bore the major responsibility for the Asian financial crisis, and it was 8 years of neoliberal restructuring that produced the Russian financial crisis.

### **Consumption and the Bubble**

The stock market bubble appears to have caused the consumer spending boom during 1997-2000. A stock bubble can increase household consumption in two ways. First, studies show that consumer spending, while primarily determined by household income, is also affected by increases in household wealth such as the value of savings accounts, home equity, and holdings of stocks and bonds. Standard estimates of this "wealth effect" on consumption are about 4 percent, which means that a wealth increase of \$100 increases consumption by about \$4. Hence, a stock market bubble, by inflating the value of stock portfolios, leads to increased consumer spending by those who own stocks.

A second effect of the bubble on consumption works through retirement pensions. Some retirement funds make pension payments that are linked to the value of the assets in the fund. The value of corporate equities held by private pension funds rose from \$1.0 trillion in 1994 to \$2.2 trillion in 1999.<sup>9</sup> As the bubble caused pension fund assets, and hence the expected future pension payments, to increase rapidly, many people may have concluded that saving out of their disposable income was unnecessary.

The size of the household wealth effect from stock price increases can be estimated from

---

<sup>8</sup> Foreign purchases of U.S. securities other than Treasury securities rose from \$130.2 billion in 1996 to \$197.9 billion in 1997, an increase of 52 percent, while U.S. purchases of foreign securities fell by \$30.8 billion between 1996 and 1997, a decline of 21 percent (US Bureau of Economic Analysis, US International Transactions Accounts Data, Table 1, December 12, 2001).

<sup>9</sup> Federal Reserve System, Flow of Funds Accounts, Table L.213, September 18, 2001.

data available from the Federal Reserve. Based on an estimated 4 percent wealth effect on consumption, the increase in the value of corporate stock held by households accounts for one full percentage point of the increase in consumer spending growth during 1997-2000, which is almost exactly the excess of consumer spending growth over what would be expected based on the growth of consumers' after-tax income. That is, the wealth effect of the stock market bubble appears to be great enough to account for nearly all of the consumption boom that propelled and prolonged the expansion after 1996.

The effect of rising equity wealth on consumer spending operates through rising household borrowing. Rather than selling their rapidly appreciating assets, households borrow against them to finance consumer spending. Household borrowing did indeed grow rapidly during the 1990s expansion. Household debt grew from 78 percent of after-tax personal income in 1991 to 91 percent in 2000. However, household debt as a percentage of total household assets did not rise over the expansion -- it was 13.4 percent in 1991 and 13.1 percent in 2000 -- which shows that rising household wealth, propelled upward largely by the stock market bubble, created the paper wealth against which households could borrow to finance their spending spree.<sup>10</sup>

The stock market bubble created an atmosphere of great optimism about the future of the economy. This encouraged borrowing and spending by the majority of the population who did not directly benefit from the rising stock prices. Household debt increased for all income groups in the population during the 1990s, and by the end of the expansion the burden of debt was much heavier on low and middle income households than on the rich.<sup>11</sup> This shows the class nature of the growing debt.

### **Investment and the Bubble**

The duration and extent of the investment boom of the 1990s, led by IT investment, cannot be explained entirely by the cost-saving potential of new information technologies. The speculative bubble also played a role. The continuing rise in corporate stock prices promoted an exaggerated view of the prospects of future profitability. Many articles and books were written

---

<sup>10</sup> Federal Reserve, Flow of Funds Account, Table B.100, December 5, 2002.

<sup>11</sup> See the Review of the Month in *Monthly Review*, 52:1, May 2000, 1-11.

claiming to prove that the rapidly ascending stock prices simply heralded unprecedented increases in future corporate profits. To the extent that corporate decision-makers believed this, it promoted a rising level of real investment, to expand capacity and cash in on those future profits. The stock market bubble also facilitated the raising of funds cheaply for investment. Some sectors of the economy used equity financing for corporate expansion, which was very cheap as a result of the high stock prices. The bubble also encouraged a large flow of debt capital into the corporate sector.

During 1995-2000 there was a huge inflow of foreign capital into the US. It was partly propelled by the Asian and Russian financial crises mentioned above, but it also was drawn by the rising bubble on the stock market.<sup>12</sup> During 1998-2000 the gross capital inflow averaged \$780.8 billion per year, which was equal to 66 percent of business fixed investment and 8.9 percent of GDP.<sup>13</sup> This capital inflow directly and indirectly helped to finance the investment boom.

Finally, the consumption boom of 1997-2000 stimulated business investment. Normally consumption spending passively follows household income, but this was not the case in the late 1990s. The increase in consumer spending due to the speculative bubble gave business a good reason to increase productive capacity through investment spending (known as the "accelerator" effect).

### **Why Inflation Remained Low**

As accelerating growth drove the unemployment rate down, there was concern, based on past experience, that inflation might take off. Contrary to this expectation, inflation remained subdued throughout the expansion. Even after 1996, when the official unemployment rate fell below 5 percent, the consumer price inflation rate never rose above 3.5 percent per year, which is low compared to earlier periods of unemployment below 5 percent. It was slumbering inflation despite low unemployment that, perhaps more than any other factor besides the stock market

---

<sup>12</sup> The inflow of capital was both a contributing cause of the bubble, and also a result of the bubble. It is part of the nature of a speculative bubble that all the sources of investment that propel it are also drawn to it by the previous bubble growth.

<sup>13</sup> Bureau of Economic Analysis, U.S. International Transactions Accounts Data, Table 1, December 12, 2001.

boom, led some analysts to proclaim that a New Economy had arisen, immune to the old trade-offs and limits. Neoliberal advocates pointed to the vigorous investment and rapid technological progress supposedly unleashed by the neoliberal restructuring as the reason why inflation remained subdued.

The way in which high investment and rapid technological progress can head off inflation is by bringing rapid labor productivity growth. With labor productivity growing rapidly, the rising real wages that normally accompany a low unemployment rate need not raise the labor cost per unit of output that firms pay. If output per labor hour rises faster than the wage per hour, then labor cost per unit of output falls, which averts upward cost pressure on prices.

As we have seen, the high investment, and the rapid technological progress in IT, did not show up very strongly in the data on labor productivity (table 2). Even in the second half of the 1990s, labor productivity grew at only 2.5 percent per year in the nonfinancial business sector, which was well below its growth rate in the 1960s and early 1970s. During 1995-2000, despite the historically low official unemployment rate, the real hourly wage rose at only 1.3 percent per year.<sup>14</sup> Thus, output per worker, while not growing very rapidly, was growing significantly faster than hourly wages, so that no upward pressure on prices resulted. This came not from impressive technological progress but from employers' ability to keep the lid on wages even when unemployment fell below 5 percent. This suggests that neoliberal restructuring contributed to low inflation despite low unemployment, not because of high investment and technological progress, but because of the sharp reduction in workers' bargaining power that resulted from that restructuring.

International factors also contributed to the low inflation rate in the US in the 1990s. Despite the growing US trade deficit in the second half of the 1990s, the international value of the dollar steadily rose rather than falling. The value of the dollar relative to other currencies rose by 31 percent from 1995 to the third quarter of 2000.<sup>15</sup> This resulted from the large capital inflow

---

<sup>14</sup> *Economic Report of the President 2002*, Table B-47, p. 376.

<sup>15</sup> The figure cited is for the trade-weighted average of a broad group of U.S. trading partners' currencies (*Economic Report of the President*, 2001, p. 400).

into the US, drawn for the speculative bubble and the financial crises abroad. A rising international value of the dollar reduces import prices, which both directly lowers the inflation rate (since imports prices make up part of the price indexes) and also puts competitive pressure on US producers that makes it difficult for them to raise prices.

### **A Neoliberal Success Story?**

Advocates of neoliberal restructuring claim that the US economy in the second half of the 1990s finally provided convincing evidence of the effectiveness of the neoliberal model. It is claimed that liberalization, privatization, and reductions in public spending, by getting the government out of the way, freeing up saving for investment, and letting the free market rule, produced an era of unprecedented prosperity in the U.S. By stimulating investment and innovation, this new model unleashed a rapid, stable growth process that benefitted all segments of society.

The evidence does not support this interpretation of the US expansion of the 1990s. Neoliberal restructuring did contribute to an expansion that lasted relatively long and yielded relatively low unemployment without much inflation. The second half of the expansion did bring growth rates of output and productivity that were better than recent experience, although they were far below the performance of the 1960s and 70s, in the era of big government. However, the channels through which neoliberal restructuring contributed to a long, low-inflation, moderately high-growth expansion were not the channels claimed by neoliberal advocates, nor were they socially healthy means of spurring economic growth.

As we have seen, cuts in taxation of business and attacks on workers' living standards raised the long-term rate of profit in the early 1990s. The rising rate of profit, together with an IT revolution which had no obvious relation to the neoliberal restructuring, set off a modest investment boom that launched the expansion. The huge and growing inequality produced by the neoliberal model soon spawned a speculative bubble, which, along with various accidental factors discussed above, led to a prolonged investment boom and eventually a consumption boom as well. The long-lasting bubble brought a long expansion. The low inflation rate resulted primarily from the successful attack on workers' bargaining power. The very slow growth of real wages

may be beneficial for capital, but it does not fit the neoliberal picture of a rising tide that lifts all boats.

Contrary to the talk about permanent prosperity, the expansion was inherently unsustainable. Every speculative bubble must eventually burst. When the bubble began to contract in the summer of 2000, investment began to fall shortly afterward. In the calendar quarter immediately following the end of stock bubble – the 4<sup>th</sup> quarter of 2000 – real business fixed investment stopped growing and began to fall. Since the end of 2000, it has fallen steadily at the rate of 6.7 percent per year through the third quarter of 2002. Consumer spending, while no longer growing at the pace of the late 1990s, has continued to increase at a 2.9 percent annual rate through the third quarter of 2002. However, with the bubble now history, at some point consumer spending is likely to shift into reverse, which would further depress business investment.

While predicting the course of a recession is a hazardous business, several features of the 1990s expansion suggest that the recession that officially started in March 2001 may be relatively severe and/or long-lasting. The very long investment boom created substantial excess productive capacity in the economy. The rate of utilization of manufacturing capacity was already at the historically low level of 80.7 percent at the end of the expansion in 2000, and it fell to 73.6 percent by December 2002.<sup>16</sup> Hence, it may be some time before a strong incentive to invest re-emerges. To make matters worse, the consumer boom of 1997-2000 stimulated a significant amount of investment in productive capacity to satisfy this demand. If consumer spending growth turns negative, much of the late-expansion investment may turn out to be surplus.

One of the chief "virtues" of the 1990s expansion holds a threat for the immediate future – the low inflation rate of the end of the expansion. A shift from expansion to recession typically brings a decline in the inflation rate. Since the inflation rate was so low at the end of the 1990s expansion, there is a danger that deflation, or falling prices, will occur, particularly if the recession lingers on for some time. Deflation can have devastating effects on the economy, as households and firms postpone purchases to await lower prices and the rising real value of debts

---

<sup>16</sup> Federal Reserve Statistical Release G.17, "Industrial Production and Capacity Utilization," January 17, 2003.

forces debtors into bankruptcy. The Japanese stagnation of the past decade provides a lesson in the harmful effects of deflation.

The long search for a neoliberal success story has, after all, not yet found one. Rather than rapid growth and rising prosperity for all, two decades of neoliberal restructuring in the US brought a speculatively-based expansion that compares unfavorably, with respect to growth rates of output and productivity, with earlier US cyclical expansions in the bad-old-days of big government. The benefits of this expansion were sharply concentrated at the top, and the speculative base of the expansion made it inherently self-limiting.

The costs of the collapse of the bubble-driven expansion are now being felt in every city and town across the US. Millions of workers have lost their jobs, while others have lost their retirement security. Local governments cannot afford to maintain essential public services at previous levels. The belief that neoliberal restructuring could somehow eliminate the crash that always follows a capitalist boom has proved unfounded. Building an economy that will bring steady progress and security for all requires, not some new (or refurbished old) form of capitalism, but replacement of the system of production for profit by a system of production to meet human needs.

**Table 1. Growth Rate of Real Gross Domestic Product Per Capita for Advanced Capitalist Countries, 1820-1992**  
(Average annual percentage rate of increase)

	<b>1820-70</b>	<b>1870-1913</b>	<b>1913-50</b>	<b>1950-73</b>	<b>1973-92</b>
Western Europe	1.0	1.3	0.9	3.9	1.8
USA	1.3	1.8	1.6	2.4	1.4

Source: Angus Maddison, *Monitoring the World Economy 1820-1992*, Paris, Organisation for Economic Co-operation and Development, 1995, pp. 60, 196-97.

**Table 2. Business Cycle Expansions in the U.S.**

<b>Years of Business Cycle Expansion</b>	<b>Real Gross Domestic Product, Annual Growth Rate<sup>1</sup></b>	<b>Output per Hour Worked, Annual Growth Rate<sup>2</sup></b>	<b>Last-Year Unemployment Rate<sup>3</sup></b>	<b>Last-Year Inflation Rate<sup>4</sup></b>
1961-69	4.9%	3.0%	3.5%	5.5%
1970-73	4.8%	3.6%	4.9%	6.2%
1975-79	4.7%	1.5%	5.8%	11.3%
1980-81	2.5%	1.3%	7.1%	10.3%
1982-90	4.0%	1.8%	5.3%	5.4%
1991-2000	3.7%	2.1%	4.0%	3.5%

1. Average annual growth rate in GDP in 1996 dollars.
2. Average annual increase in output per hour in the nonfarm business sector.
3. Civilian unemployment rate in last year of expansion.
4. Percentage increase in the Consumer Price Index in last year of expansion.

Source: US Bureau of Economic Analysis, National Income and Product Accounts, August 29 and November 30, 2001; US Bureau of Labor Statistics, Major Sector Productivity and Costs Index, Series ID PRS85006093, September 27, 2001; US Bureau of Labor Statistics, Consumer Price Index, Series ID CWUR0000SA0, December 15, 2001.

(Annual average percentage rate of increase)

	<b>1991-95</b>	<b>1995-2000</b>
(1) Information processing equipment and software	14.2	20.2
(2) Equipment other than information processing equipment and software	8.4	5.5
(3) Structures	0.0	5.4
(4) All business fixed investment	7.6	10.6

1. All growth rates are calculated in 1996 dollars.

Source: US Bureau of Economic Analysis, National Income and Product Accounts, Table 5.5, August 29, 2001.