THE GLOBAL FINANCIAL CRISIS

Economists, Recessions, and Profits*

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In the autumn of 1929, Irving Fisher, a renowned Yale economics professor, made a statement that soon became famous for its stunning inaccuracy. Just weeks before the stock market crash that marked the beginning of the Great Depression, Fisher proclaimed that stock prices had reached "what looks like a permanently high plateau."[1] In spite of Fisher's opinion, the Dow Jones index of stock market prices dropped by almost half in just a few weeks and continued gyrating wildly but persistently downward for another two-and-a-half years, while the real economy contracted to unprecedented levels.

Almost eight decades later on September 19, 2007—a time when news of financial troubles related to mortgages and the real estate market in the United States had been appearing in the media for several months—University of Chicago economist Robert E. Lucas, a recipient of the 1995 Nobel Memorial Prize in Economic Sciences, wrote the following in *The Wall Street Journal*:

> I am skeptical about the argument that the subprime mortgage problem will contaminate the whole mortgage market, that housing construction will come to a halt, and that the economy will slip into a recession. Every step in this chain is questionable, and none has been quantified. If we have learned anything from the past 20 years, it is that there is a lot of stability built into the real economy.[2]

Two years after Robert Lucas's remarks on the "stability built into the real economy," another recipient of the Nobel Memorial Prize in Economic Sciences, Paul Krugman, published in *The New York Times Magazine* a long article titled "How Did Economists Get It So Wrong?"[3] For Krugman, the great recession of 2008 had shown how wrong economists who congratulated themselves over the success of their field were. Krugman wondered how the profession had been able to blunder so egregiously in believing that economists had resolved their internal disputes; that the state of macroeconomics was good—as pretended, for instance, by Olivier Blanchard, chief economist at the International Monetary Fund; and that the "central problem of depression-prevention has been solved," as Robert Lucas had previously declared in 2003.

To my knowledge, only John Cochrane of the University of Chicago School of Business presented a more-or-less articulate reply to Krugman's scathing attack. Cochrane fired back that Krugman, by challenging the validity of the entire economics profession, was betraying it.

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[1] John K. Galbraith, *The Great Crash 1929* (New York: Pelican, 1961).

[2] Robert E. Lucas, Jr., "Mortgages and Monetary Policy," *Wall Street Journal*, September 19, 2007, p. A20.

[3] Paul Krugman, "How Did Economists Get It So Wrong?," *The New York Times Magazine*, September 2, 2009.

> Imagine this weren't economics for a moment. Imagine this were a respected scientist-turned-popular-writer, who says, most basically that everything everyone has done in his field since the mid 1960s is a complete waste of time. Everything that fills its academic journals, is taught in its PhD programs, presented at its conferences, summarized in its graduate textbooks, and rewarded with the accolades a profession can bestow, including multiple Nobel prizes, is totally wrong.[4]

Cochrane charged that Krugman was calling for a return "to the eternal verities of a rather convoluted book written in the 1930s." (Cochrane was referring obviously to Keynes's *General Theory*.) He also said Krugman "hints at dark conspiracies," indulges in a "calumnious personal attack on an ever-growing enemies list," makes stuff up, puts words in economists' mouths that run contrary to their written opinions, and goes as far as to accuse them of adopting ideas for pay, and selling out for fat Wall Street paychecks and sabbaticals at the Hoover Institution.

It would be difficult to date it with precision, but it appears that the recent infighting among economists began as recently as the early months of 2009. From the outbreak of the financial crisis in late 2007 until that time, the general climate among economists and economic commentators had been one of generalized stupor. Mainstream economists, economic commentators, and conservative politicians—who had championed *laissez faire* economic policies, balanced budgets, and the lowest possible taxes—were conspicuously silent, or seemed to have suddenly accepted the Keynesian tenets championed by economists like Paul Krugman and Joseph Stiglitz. If the issue was to save the financial system—which actually meant the riches of bank owners and millionaire partners of hedge funds—political intervention was welcome. In the months before and after the election of Barack Obama at the height of the global financial crisis, governments around the world, elected representatives, and economic commentators agreed on doing "the only thing that could be done—that is, inject massive quantities of taxpayer funds into the financial system to avoid a system-wide collapse of banks, insurance companies, investment funds, and all the other institutions that make up the so-called financial sector. Even Doug Henwood of the *Left Business Observer* said there was no alternative to bailing out the financial system. The chorus of economists, various experts, and public officials claimed that we were all held hostage by the banks, because letting banks and financial corporations like AIG go down would have meant the demise of the whole society.[5]

Before the current financial crisis hit, disagreements among most economists and between Republican and Democratic politicians on economic policy were mostly on the details and the nuances. They all basically agreed on cutting taxes—the major thrust of George W. Bush's economic policy—as evidenced by the bipartisan-supported economic stimulus of early 2008 that so miserably flopped. Cracks began to appear in the basic consensus when the financial crisis erupted, and then-U.S. Treasury Secretary Henry Paulson initiated the policy of throwing billions of public dollars into the black hole of bank debts

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[4] John Cochrane, "How did Paul Krugman Get it so Wrong," September 16. 2009, online at: http://faculty.chicagobooth.edu/john.cochrane/research/Papers/krugman_response.htm.
[5] Doug Henwood, "The Deepening Economic Disaster," December 8, 2008, online at: http://nyusociology.org/blogs/radical/2008/12/08/the-deepening-economic-disaster/.

that resulted from the failing worldwide market of derivatives.[6] During the late months of 2008, however, the bailouts to banks and financial institutions created a groundswell of public outrage.[7] It was not surprising, then, that in the last months of 2008, economic commentators linked to unions or liberal think tanks started to call for bailout measures to be directed to help the real economy—the millions of workers who were losing their jobs or home-owners at risk of foreclosure.[8] At the same time, more conservative economists like Gregory Mankiw timidly expressed doubts about the soundness of big government spending because of the enormous public debt it would leave to future generations.[9] Hal Varian, the author of a standard text of microeconomics, joined the chorus approving the bailouts of the financial institutions, adding that promoting private investment would be the best way to stimulate the economy.[10]

The inauguration of Obama as U.S. president, the vote in the U.S. House of Representatives for Obama's stimulus plan, and the fact that major voices began using the term "nationalization" in discussing what should be done with the failing bank sector in the United States[11] seem to have been the incantations that broke the spell. On January 28, 2009, the same day that all but a handful of Democrats in the House voted to pass the $825 billion stimulus package without even one Republican voting in favor, the libertarian Cato Institute ran a full page ad in *The New York Times*. The ad was a rebuttal to the economic stimulus, signed by more than 200 economists, including major names like Eugene Fama, Deepak Lal, Deirdre McCloskey, and the Nobel laureates James Buchanan, Edward Prescott, and Vernon Smith. Titled "With all due respect, Mr. President," the ad challenged Obama's assertion that there was general agreement that government action was needed for "a recovery plan that will help to jumpstart the economy." The ad stated that:

> Notwithstanding reports that all economists are now Keynesians and that we all support a big increase in the burden of government, we do not believe that more government spending is a way to improve economic performance. More government spending by Hoover and Roosevelt did not pull the United States economy out of the Great Depression in the 1930s. More government spending did not solve Japan's "lost decade" in the 1990s. As such, it is a triumph of hope over experience to believe that more government spending will help the U.S. today. To improve the economy, policy makers should focus on reforms that remove impediments to work, saving, investment and production. Lower tax rates and a

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[6] Derivatives are highly complex investment instruments (e.g., futures contracts, swaps, repurchasing options, collateralized debt obligations, etc.) that are derived from some other physical or financial asset such as oil, coal, wheat, mortgages, etc. When derivatives were developed, they were presented as instruments that would allow investors to hedge against sudden fluctuations in the markets. Speculation with derivatives became widespread and the subsequent volatility of derivative prices, which during 2008 basically dropped to zero, became one key element triggering the global financial crisis.

[7] Robert Blendon and John Nenson, "America's Response to a Deep Recession," *Challenge*, Vol. 52, No. 4, pp. 32-52.

[8] Tom Palley, "Motor City Meltdown, November 25, 2008," online at: http://www.thomaspalley.com; Tom Palley, "The Liquidation Trap," September 17, 2008," online at: http://www.thomaspalley.com.

[9] Gregory Mankiw, "What Would Keynes Have Done?" *The New York Times*, Nov. 30, 2008, online at: http://www.economics.harvard.edu/faculty/mankiw/files/What percent20Would percent20Keynes percent20Have percent20Done.pdf.

[10] Hal Varian, "Boost Private Investment to Boost the Economy," *Wall Street Journal*, Jan, 7, 2009.

[11] Joseph E. Stiglitz, "How to Rescue the Bank Bailout," *CNNPolitics.com*, Jan. 26, 2009, online at: http://www.cnn.com/2009/POLITICS/01/26/stiglitz.finance.crisis/index.html.

> reduction in the burden of government are the best ways of using fiscal policy to boost growth.[12]

During 2009, major blows were exchanged in the intellectual debate on the present crisis. Arguments sprang up between Keynesian economists supporting the interventionist, though often considered insufficient, actions of the administration and the more conservative economists, who echoed the criticism of the Republican party, which was scandalized to the marrow by the increasing level of "socialism" the Obama administration was displaying. Economists like James K. Galbraith,[13] Paul Krugman, and Joseph Stiglitz, who are considered to the left of the Obama Administration—to use a conventional terminology—argued that the stimulus was not big enough and countered that the director of President Obama's National Economic Council, Larry Summers, and Treasury Secretary Timothy Geithner, were applying an economic policy of socialism for the rich.[14] Aside from charging that the Obama Administration was pushing America toward socialism, Republicans also objected that the stimulus would lead to major financial turmoil and inflation. While Robert Barro defended the orthodoxy of neoclassical economics and labeled the government's Keynesian policy of fiscal stimulus "voodoo economics,"[15] Paul Krugman shot back that we were living in a Dark Age of macroeconomics[16] and further that work in macroeconomics over the past 30 years was useless at best and harmful at worst.[17] His article on how economists got it so wrong was the major intellectual bomb to date in the economic controversies triggered by the 2008 recession—controversies that very likely will continue in the future.

Beyond the spectacle of the uproar among academic economists—always a pleasure to see for those who believe that what is taught today as economics is, to a large extent, useless for understanding economic and social reality—the dark truth was that the world economy was plunging into a deep hole in which millions of people were losing their jobs.

What Causes Recessions?

Economists use a multiplicity of theories, many of them mutually contradictory, to explain the basics of the economy: the recurrent expansions and recessions, or boom and bust cycles—in economic jargon, the so-called "business cycle." The big problem, Cornell College economist Todd A. Knoop points out, is that unfortunately,

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[12] The text is available at: http://www.cato.org/special/stimulus09/cato_stimulus.pdf.

[13] James K. Galbraith, "Statement by J.K. Galbraith, Chair in Government/Business Relations, Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin, before the Committee on Financial Services, U.S. House of Representatives, February 26, 2009." *MRzine*, online at: http://mrzine.monthlyreview.org/galbraith270209p.html; James K. Galbraith, "Bailed-Out Banks Should Be Declared Insolvent," *Democracy Now!*, February 10, 2009, online at: http://www.democracynow.org/2009/2/10/economist_james_galbraith_bailed_out_banks.

[14] Paul Krugman, "Boiling the Frog," *The New York Times*, July 13, 2009, p. A17; Joseph E. Stiglitz, "America's Socialism for the Rich," *The Guardian*, June 12, 2009, http://www.guardian.co.uk/commentisfree/2009/jun/12/america-corporate-banking-welfare

[15] Robert Barro, "Voodoo Multipliers," *The Economists' Voice*, Vol. 6, No. 2, 2009, pp. 1-4.

[16] Paul Krugman, "Boiling the Frog."

[17] Anonymous, "Paul Krugman's London Lectures: Dismal Science - The Nobel Laureate Speaks on the Crisis in the Economy and in Economics," *The Economist*, June 11, 2009.

> after more than 200 years of debate, there is still no general agreement about what causes recessions and depressions. Multiple competing models of business cycles continue to be used among economists. In fact, there is a large disconnect between the models used by academics and those used by private sector economists.[18]

When the financial crisis erupted, some immediate answers to the obvious question of "why is this happening?" were tossed out to the public. The word *greed* was often heard in the early months of 2008, as if greed were not a basic component of our economy, which is premised upon thousands of free enterprises trying to produce as much money profit as possible, all supposedly to serve the common good. Greed did not seem to be a very plausible explanation, however, and other things emerged. For neoclassical economists and conservative politicians, the market economy is a kind of perfect mechanism that works to the utmost efficiency—as long as it is not disturbed by exogenous interferences. Such interference can come from the government, worker unions, monopolies, or any number of factors that prevent the natural tendency of markets to reach equilibrium.[19] Therefore, if markets were not working properly, it had to be because the government had done something that had disturbed them. Early in the crisis, the guilty parties were said to be Fannie Mae and Freddie Mac, the U.S. government-backed mortgage lenders who were accused of distorting the real estate market. In contrast, economists in the Keynesian tradition, usually linked to the left wing of the Democratic party, blamed speculation unchecked by financial regulation for the crisis. They claimed that an appropriate set of regulations of financial markets had been put in place during the Great Depression and the years immediately following, which had allowed for the stability and growth of the 1950s and 1960s. However, these regulations had been progressively dismantled in later decades, which allowed for the irrational speculative investment and lending that led to the financial crash. In one version of this story, the lack of regulation led to successive bubbles, first in the stock market, then in real estate.[20] A different but complementary story often posed by the moderate Left is that the lack of purchasing power for popular consumption—i.e., underconsumption—was one determining factor, if not *the* factor, producing the crisis.[21]

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[18] Todd A. Knoop, *Recessions and Depressions: Understanding Business Cycles* (Westport, CT: Praeger, 2004), p. 4.

[19] In the late 19th century Stanley Jevons considered sunspots as responsible for economic downturns—via weather fluctuations causing changes in harvests. A few decades later another prestigious economist, Henry Ludwell Moore, tried to prove that movements of planet Venus and rain cycles were the factors recurrently causing expansions and recessions. See Mary S. Morgan, *The History of Econometric Ideas* (Cambridge: Cambridge University Press, 1990). Though these "celestial" explanations of economic fluctuations no longer fly in the economic sky, in the 1980s Ravi Batra, a professor of Economics at Southern Methodist University, published a book, *The Great Depression of 1990* (New York: Simon & Schuster, 1987), predicting a major crash of the world economy in 1990 by using a kind of numerology in which the ending digit of specific years (for instance the 1 in 1921 and 1981) had a major role in determining the likelihood of economic events. The book was published with a preface by the renowned Lester Thurow, who referred approvingly to the "cyclical regularities, of which Batra gives a novel and brilliant exposition."

[20] Dean Baker, *Plunder and Blunder: The Rise and Fall of The Bubble Economy* (Sausalito, CA: PoliPointPress, 2008).

[21] For a very rough version of the underconsumptionist theory, that is, the idea that economic crises are caused by lack of demand due to too low wages, see Jonathan Tasini, "Is the Recession Over? Democratic Senate Hopeful Jonathan Tasini on 'The Audacity of Greed: Free Markets, Corporate Thieves and the Looting of America,'" October 30, 2009, online at: http://www.democracynow.org/2009/10/30/tasini. A much more sophisticated version, in which the ideas of Marx and Keynes are combined (or rather mixed up in the *Monthly Review* tradition of Sweezy and Baran) has been recently presented by John Bellamy Foster in "Keynes, Capitalism, and the Crisis," *MRzine,* March 2009, online at: http://www.monthlyreview.org/mrzine/foster170309.html).

This narrative ignores the basic fact that for the few years preceding the 2008 crisis, a moderate though real increase in real wages had occurred.

In summary, both liberal and conservative thinking on why recessions happen blames exogenous factors coming from outside of the economic sphere and therefore implies that if these were removed, the economy would work properly. Thus, the culprit could be undefined "productivity shocks," the government, greed, George W. Bush (or perhaps Dick Cheney), the lack of financial regulations, or the insufficient purchasing power caused by low wages—anything but the boom-and-bust cycle that is inherent in capitalism.

In his "How Did Economists Get It So Wrong?," Krugman harshly criticized the lack of appropriate explanations of recessions in economics and mocked neoclassical economists like Lucas, who "argued that recessions were caused by temporary confusion: workers and companies had trouble distinguishing overall changes in the level of prices because of inflation or deflation from changes in their own particular business situation." However, beyond attacking what for him were mad or laughable explanations of recessions, declaring that "a more or less Keynesian view is the only plausible game in town," Krugman said very little on the possible factors causing recessions.

Instead Krugman propounded an explanation of recessions based on limited human rationality and the imperfection of *financial* markets. Interestingly, only a few years earlier, he had emphatically asserted a different monetary explanation of recessions. Then he said it is possible for an economy to get into a situation in which overall demand is inadequate, so that recessions do indeed happen:

> However, such slumps are essentially monetary—they come about because people try in the aggregate to hold more cash than there actually is in circulation. (That insight is the essence of Keynesian economics.) And they can usually be cured by issuing more money—full stop, end of story.[22]

Interestingly, in Krugman's "How Did Economists Get It So Wrong?," the word "profit" does not appear once.

Profits and the "General Glut" Controversy

From the time that the present "free enterprise" economic system took hold in 18th century England and then spread throughout much of the world, the issue of the causes of booms and busts has been raised every time there has been widespread business failures and mass unemployment. After the free enterprise economic system began to have a well-defined existence, it was referred to by different names. In its early days, it was sometimes called "the factory system." Adam Smith called it "the commercial society," Marx "the bourgeois economy," and other authors "capitalism." The institutionalist Wesley Mitchell called it "the money economy," or "the profit economy," a term that most aptly describes it.

[22] Paul Krugman, "All Work and No Play Makes William Greider a Dull Boy," *Slate*, Jan. 24, 1997, online at: http://www.slate.com/id/1916.

Authors who centuries ago began studying the workings of the system of trade and industry in which money fulfills a major role noticed that profit was a primary component of it. The concept of profit figures prominently in the writings of authors like Ibn Khaldun (1332-1406) and Richard Cantillon (1680-1734), who are considered forerunners of modern economic science. The concept of profit is also prominent in the works of Adam Smith and David Ricardo, the usually undisputed founders of the discipline.

During Ricardo's time, a controversy developed when the French economist Jean Baptiste Say argued that it was impossible for a "general glut" of the market to occur, though partial gluts in a given sector could take place if too much of something was produced in a particular sector. The controversy was not merely theoretical, since there had been several periods in which the economy was seriously disturbed, markets overflowed with unsold products, business failures multiplied, and workers were laid off in great numbers.

Say held that "supply creates its own demand," and the flows of money created in the production of all goods and services supplied to the market (money paid for wages, for raw materials, for land, etc.) must be sufficient to buy back—that is, to create effective demand for all those goods and services.

Ricardo and most economists of the time followed Say in rejecting the possibility of a general glut. However, though the concept of profit was a key element for Smith, Ricardo, and in the political economy of the early 19th century, in the controversy on the general glut, the concept of profits was basically ignored. When political economy became the academic discipline of economics in the last decades of the 19th century, two of its most important concepts were Adam Smith's invisible hand, which is said to "organize" producers and consumers so that from their interaction an optimum outcome emerges, and Say's law that a general glut—a general situation of total supply exceeding total demand—is not possible. Economists then generally accepted that a self-correcting mechanism would lead markets themselves to avoid any major disruption, or at least to recover quickly. This thinking—that markets were naturally oriented toward equilibrium and harmony absent any planned intervention—was prevalent when the Great Depression hit the world in the 1930s. Thus, prominent economists like Irving Fisher and Joseph A. Schumpeter followed the basic tenets of their science and claimed that markets would recover by themselves. In their view, the best thing governments could do was to allow the economy to heal itself—a dangerous prescription, since millions were either already unemployed or losing their livelihoods and needed income to meet their basic life needs. If markets were going to recover themselves, they were taking quite a long time, because the dreadful decay in economic activity that took place in 1930 continued for three years before visible signs of recovery appeared in mid-1933.

In the 19th century, major critics rejected Say's law and the idea that general gluts were impossible. Three prominent ones were Thomas R. Malthus, Simonde de Sismondi, and Karl Marx, all of whom said general gluts were indeed possible. They argued that situations where total supply exceeded total demand were common in the history of modern commercial nations. Nevertheless, while Malthus defended the status quo and believed general gluts were basically short-term problems that could be solved by allowing for increased consumption by landlords, both Sismondi and Marx considered general gluts—or industrial crises, as Marx called them—to be symptoms of the irrationality of the capitalist economic system. While Sismondi protested against *laissez faire* and invoked the need of the state to regulate the progress of wealth, Marx claimed that another economic system was both possible and necessary to overcome the recurrent decays of capitalism and the social ailments caused by its basic component, wage labor.

Sismondi and Marx were, however, under a permanent cloud of unacceptability among academic economists, and when the idea that general gluts were possible came to the fore again in the 20th century in the work of John Maynard Keynes, its source and its intellectual pedigree was Malthusian.

Profits During the Great Depression

Before the Great Depression hit economies worldwide in the early 1930s, major recessions had occurred in the 1920s in several European countries, and governments had started to intervene in the economy to ameliorate persistent unemployment. In the United States, it was President Franklin D. Roosevelt who in 1933, under the force of circumstances, initiated the programs to stimulate the economy that were collectively known as the New Deal.

Economists of different schools have presented various views on the causes of the Great Depression and the gestation and effects of the New Deal.[23] Given the general lack of agreement among economists on the causes of recessions, it is not surprising that prominent economists have a variety of sharply contradictory explanations about the collapses that the United States and other countries underwent during the 1930s. In their book *A Monetary History of the United States, 1867-1960*, Milton Friedman and Anna Schwartz lay out the basic conservative economic explanation of the Great Depression of 1930-1933 as incompetent monetary policy intervention by the Federal Reserve, which they say turned a common recession into The Great Depression. Robert Lucas added to this explanation with his rational expectations theory. In spite of incontrovertible historical evidence that millions were desperate for a job between 1930 and 1933, Lucas callously suggested that they were just having a great vacation. Since prices and wages were falling during those years, he said “people had to revise their hopes and aspirations for pay downward. As the thing goes on and on more and more people get wise and people take jobs in 1932 that they wouldn’t have even looked at in 1930.”[24]

Economists’ opinions aside, the major facts on the Great Depression of the 1930s are not disputed. Following a period of accelerated economic growth in “the roaring twenties,” the economy weakened beginning mid-1929, until the stock market crash in October 1929, which developed into a severe decay of economic activity that continued for three years. The unemployment rate, which had been less than 3 percent in the late 1920s, reached almost 23 percent in 1932. Economic activity eventually began recovering by mid-1933. By 1935, the unemployment rate had dropped to 14 percent, and down to 10 percent in 1936. A new downturn started in 1937, and the unemployment rate rose to almost 13

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[23] Randall E. Parker (ed.), *Reflections on the Great Depression* (Cheltenham: Edward Elgar, 2002); Randall E. Parker (ed.), *The Economics of the Great Depression: A 21st Century Look Back at the Economics of the Interwar Era* (Cheltenham: Edward Elgar, 2007).
[24] R.E. Parker, “Interview with Robert Lucas,” in R.E. Parker (ed.), *The Economics of the Great Depression*, p. 89.

percent in 1938, falling back to 11 percent in 1939.[25] The start of World War II and the massive program of military build-up accelerated the economy in the early 1940s, and eventually unemployment was reduced to pre-1930s levels.

Between 1929 and 1993, a quarter-million business firms in the United States—among them hundreds of banks—disappeared. The most dramatic declines in the number of firms were in manufacturing, where the total plunged by 35 percent, and in construction, where it dropped by 21 percent. The financial distress in the business sector was, however, very uneven; corporations with more than $50 million in assets maintained positive profits throughout this period.[26] However, so-called "mom and pop" businesses were major casualties of the crash of the early 1930s, a scenario that has repeated itself in the slump of 2008-2009.

In the first three years of the 1930s as millions of workers lost their jobs, wages declined under the pressure of mass unemployment. By 1933, weekly wages in manufacturing had dropped to about two-thirds of what they were in 1929. The reduction of competition and the expanded market share for the firms that had not failed, the low cost of wages and raw materials, and the prescriptions of the National Recovery Administration that permitted businesses operating in the same sector to agree on prices to allow for a generous profit margin[27] made investment an attractive option again for the wealthy, and industrial activity jumpstarted.[28] For the economy as a whole, profits that had been negative in 1932 and 1933 became positive in 1934, growing 42 percent in 1935 and 45 percent in 1936. However, though industrial and business activity had generally strongly rebounded, it remained dependent to a considerable extent on government purchases financed with deficit spending. The deficit of the federal budget had been just $1.8 billion in 1933 (3.5 percent of the gross national product, GNP) but rose steadily in the next three years to reach a peak of $4.6 billion in 1936 (5.5 percent of GNP). Then the Roosevelt Administration decided to reduce deficits by cutting government spending. When the deficit dropped to about $3 million in 1937 and little over $1 million in 1938, economic activity sunk again, and unemployment surged to over 10 percent.

The recovery of 1933 and the empirical evidence of the other historical examples of expansions and recessions, including the 2008 recession, indicate that business profit is the basic driver of the market economy. Indeed, since profit is the surplus money obtained when money is "invested," a business is simply a pile of money "organized" to get more money. This is applicable both to big corporations such as Boeing or Microsoft and to tiny "mom

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[25] These and other statistics on the 1930s discussed through the article are from Susan B. Carter, et al., *Historical Statistics of the United State*s, Millennial Edition Online (New York: Cambridge University Press, 2006), tables Ba470-477 and Cj251-264.

[26] Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review*, Vol. 73, No. 3, 1983, pp. 257-276.

[27] Maurice W. Lee, *Economic Fluctuations: An Analysis of Business Cycles and Other Economic Fluctuations* (Homewood, IL: R.D. Irwin, 1955).

[28] In the U.S. economy during the period from the Great Depression to the 1990s, observed profitability during any given year and the previous year is the main variable determining the rate of investment by business enterprises. See Olivier Blanchard et al., "The Stock Market, Profit, and Investment," *Quarterly Journal of Economics*, Vol. 108, No. 1, 1993, pp. 115-136.

and pop" businesses like those that Republicans so proudly tout as a key element of the American economy. There is no business without profit.

Profits Drive the Business Cycle

Although academic writings on the business cycle often cite Wesley Mitchell, his ideas are usually absent from modern economic thought. While Mitchell emphasized observable factors and institutions, focusing on the central role of profits and market failures in producing unemployment and business bankruptcies, modern economics emphasizes mathematical models based on unrealistic assumptions of perfect markets, with economic agents freely "choosing" to be unemployed or work the quantity of hours they like.

Writing almost a century ago, Mitchell explained that the money economy

> is one of the ancient institutions which after a checkered history has attained its fullest development in our own day under the influence of machine production and railway transportation. The essential feature of this institution is not the use of money as a medium of exchange; but the fact that economic activity takes the form of making and spending money incomes. Instead of producing the goods their families require, men "make money," and with their money incomes buy for their own use goods made by unknown hands (...) Natural resources, mechanical equipment, and industrial skill are factors of fundamental importance under any form of economic organization. But where money economy dominates, natural resources are not developed, mechanical equipment is not provided, industrial skill is not exercised, unless conditions are such as to promise a money profit to those who direct production.[29]

It is hard to know if Mitchell was conscious that by assigning profit a key role in the workings of the economy and mentioning that "those who direct production" and reap profits are obviously separated from "the people," he was questioning basic tenets of modern economics—particularly the claim that a productive system in which each producing unit competes with the others for profits is the best way to serve the common good.

Regardless, almost 40 years later, Mitchell continued emphasizing the key role of profits:

> Since the quest for money profits by business enterprises is the controlling factor among the economic activities of men who live in a money economy, the whole discussion [of expansions and recessions] must center about the prospects of profits. On occasion, indeed, this central interest is eclipsed by a yet more vital issue—the avoidance of bankruptcy. But to make profits and to avoid bankruptcy are merely two sides of a single issue—one side concerns the well-being of business enterprises under ordinary circumstances, the other side concerns the life or death of the same enterprises under circumstances of acute strain.[30]

As Mitchell explained, recessions often start with a financial crisis in which banks, insurance companies, and other financial firms go bankrupt. But underneath the phenomena in the financial sphere, in the so-called real economy where goods and services are produced, recessions are preceded by a set of processes that encroach on profits at least in a score of

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[29] "Wesley Clair Mitchell, *Business Cycles* (Berkeley: University of California Press, 1913), pp. 21-22.
[30] Wesley Clair Mitchell, *Business Cycles and Their Causes: A New Edition of Mitchell's Business Cycles*, *Part III* (Berkeley: University of California Press, 1941), Preface.

major enterprises or industrial sectors. This stagnation of profits in some parts of the economy creates financial strain and reduces sales in other sectors of the economy, all of which in turn reduces the incentive to keep or build up inventories. Investment in wages, raw materials, and new machines or production facilities also falls, which eventually reduces the level of business activity, since business failures and reduction of business activity decrease both wages and investment, which are the two basic sources of demand. This is a vicious cycle that may operate for months or years, sending the economy into a downturn that can range in severity and length from a mild recession to a great depression.

Though Marx's ideas on the business cycle are scattered and incompletely presented,[31] he saw in economic crises themselves—that is, recessions—the built-in mechanism that brings the economy back to expansion.[32] Marx noted that during periods of economic expansion, profits grow only to eventually decline, which triggers the crisis. But the crisis itself—by eliminating business, as putting downward pressure on wages as a result of massive unemployment, and slashing the price of machinery, buildings, raw materials and other capital goods—eventually creates the conditions for consolidation and centralization of capital, new profitable investment, and new expansion.

The similarities of the views of Marx and Mitchell on the dynamics of the economy have been rarely mentioned,[33] but they are remarkable—and likely the reason why Mitchell's analysis is usually ignored in modern economics. Since the times of Smith, Ricardo, and Malthus, economics has developed as a discipline that valorizes the market economy as a social arrangement that creates progress for the common good. The general glut controversy, the views of pre-Keynesian economists on the natural tendency of markets to reach equilibrium and recessions to solve themselves, the idea that the business cycle had been overcome and become obsolete—in fashion during the 1960s[34]—are all examples of the underlying tendency of economics to deny or ignore the actual history of capitalism, which has shown it to be a social and economic system repeatedly subjected to more or less severe fluctuations and crises. More recently the acceptance of the two concepts, the so-called "New Economy" and "the Great Moderation," illustrate the tendency of academic economics to paint the economic future in rosy hues. The "New Economy" describes the transformation of high-income countries from manufacturing-based into service sector asset-based economies, which has been brought about by globalization and central bank policies that supposedly created a state of permanent steady growth, low unemployment, and immunity to boom-and-bust cycles. "The Great Moderation" refers to the prediction that the modest economic fluctuations that occurred in the 1980s and 1990s signaled a future of sustained and stable economic growth.[35] Neither Marx's nor Mitchell's views on the centrality of profits and the endogenous character of business cycles—and therefore the inevitability of economic crises—fit the *Weltanschauung* of the discipline.

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[31] Mainly in volumes 2 and 3 of *Capital*.

[32] William J. Blake, *An American Looks at Karl Marx: Elements of Marxian Economic Theory and its Criticism* (New York: Cordon, 1939).

[33] An exception is the paper by Howard Sherman, "The Business Cycle Theory of Wesley Mitchell," *Journal of Economic Issues*, Vol. 35, No. 1, 2001, pp. 85-98.

[34] Martin Bronfenbrenner, *Is the Business Cycle Obsolete?* (New York: Wiley-Interscience, 1969).

[35] Ben S. Bernanke, "Remarks on The Great Moderation by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, D.C., February 20, 2004," online at: http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2004/20040220/default.htm.

The Corporate Class and the Great Recession of 2007-2009

Beyond being a scientist focused on the economy and the economic institutions of society, Mitchell was a moderate seeking social reform and technical means to avoid the disruptions provoked by business cycles. In contrast, Marx was a revolutionary seeking major social change in the society at large. In his analysis of the economy, Marx always included the role of political and social institutions; indeed, Marxian theory can be considered an integrated vision of the bourgeois society in which such disciplines as history, sociology, political science, economics, and anthropology are basically unified.

In Marx's analysis, the bourgeois society is a social formation in which capital has the political, social, and economic power. Even under democratic conditions and elected governments, the ruling class is the class of capital owners. The great recession of 2008 illustrates the class character of the State and the key role of governments worldwide in maintaining the workings of the capitalist economy and the economic and political power of big business. In the particular case of the Unites States, since the autumn of 2008, the federal government, first under a Republican administration and then a Democratic one, pumped billions of taxpayer dollars into the financial system. President Obama said that this had to be done to avoid the whole system "falling down on our heads." However, it is very arguable to what extent the nationalization of several dozen failed banks and insurance companies would have triggered a bigger social crisis than the one that actually occurred and is still with us. What is not arguable, however, is that by saving Citibank, Bank of America, AIG, and other major financial corporations, the government of the United States helped to maintain the value of major investments. Particularly by saving AIG, the insurance company that insured other financial companies in their stock market ventures, the government's intervention created the conditions for massive transfers of taxpayer money to the banks through the conduit of insurance payments by AIG.

The Prospects

During the second half of 2009, pronouncements that financial markets are stabilizing and the economy is likely on track for recovery began appearing in the media. Since bottoming out in March 2009, the stock market rose steadily, though unemployment rates continued climbing to double-digit levels in November for the first time since the 1980s. It is true that unemployment is a lagged indicator that may continue climbing for several months after the economy has started expanding again. Equally, in downturns, unemployment often takes a while to rise once the economy stops growing. Leaving unemployment aside, if profits are the engine of the economy, their recent evolution (figure 1) shows that economic conditions have changed. Since the fourth quarter of 2008 when corporate profits fell to a trough of $1.12 trillion, profits have risen. They had precipitously dropped during 2008 and had been falling since the third quarter of 2007, when they had reached a pre-recession peak of $1.66 trillion.[36]

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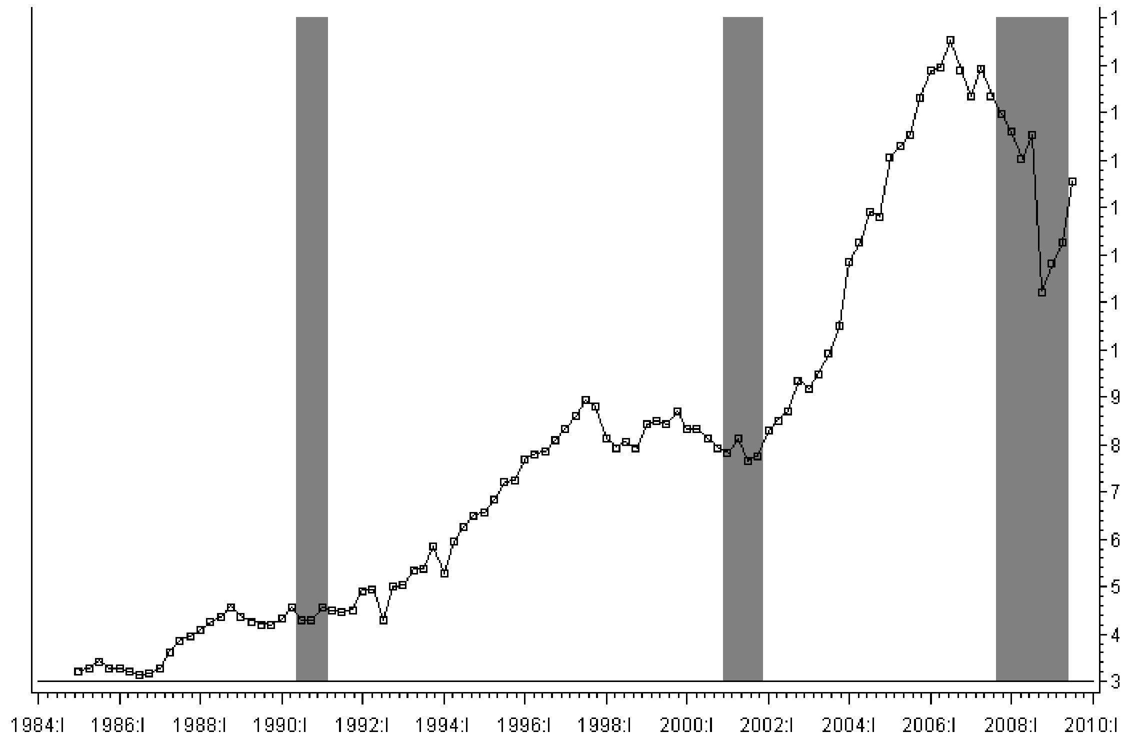
[36] This figure for annualized profits in the third quarter of 2006 as reported in December 2009 on the website of the Bureau of Economic Analysis (BEA) is $1,655.1 billion. A few months earlier the reported figure for that quarter on the BEA website was $1,713.8 billion, while according to news published in August 2008, the peak in profits, also as reported by the BEA, had been $1.27 trillion (i.e., $1,270 billion). See Floyd Norris,

Figure 1. Corporate profits and recessions (shaded areas) as dated by the National Bureau of Economic Research



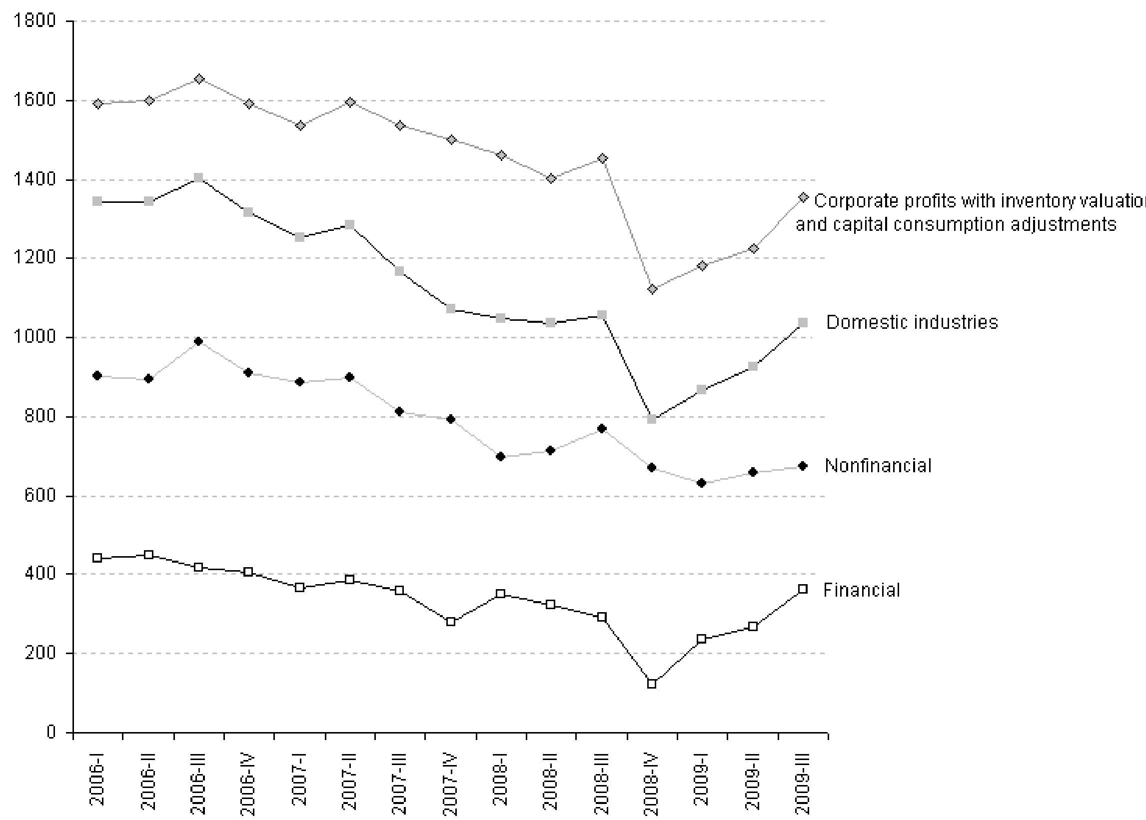
Sources: Table 6.16, National Income and Product Accounts (NIPA), U.S. Bureau of Economic Analysis, online at: http://www.bea.gov/, accessed December 2009. Corporate profits, in billions (right scale), are quarterly data, from the first quarter of 1985 to the third quarter of 2009, with inventory valuation and capital consumption adjustments, seasonally adjusted at an annual rate. Recessions are periods from one peak to the next trough of the business cycle as defined in the chronology of the National Bureau of Economic Research, online at http://www.nber.org/cycles.html. The graph is printed as if the recession dated by NBER as beginning in the third quarter of 2007 had lasted until the second quarter of 2009. As of December 2009, NBER had not dated the end of this recession.

The role of profits as the leading factor driving an economic boom as they grow and then generating an economic bust when they stagnate or fall can be shown formally with statistical methods that are beyond the scope of this article. However, the evolution of profits from 1985 to the present (figure 1) shows how profits stagnated or even began to decline several quarters before each of the three recessions starting respectively in 1990, 2001, and 2007. Profit data going back to the last decades of the 19th century, when they were first collected, shows that something similar occurred in each of the recessions that the U.S. economy has gone through since that time.

"Profit Data May Explain U.S. Gloom," *The New York Times*, August 1, 2008. Since profit estimates are computed on tax returns and enterprises have all kind of incentives to exaggerate profits for stock market purposes and underreport them for tax purposes, figures as those plotted in figure 1 must be taken as just revealing general patterns, and little confidence can be given to the particular level for any given quarter.

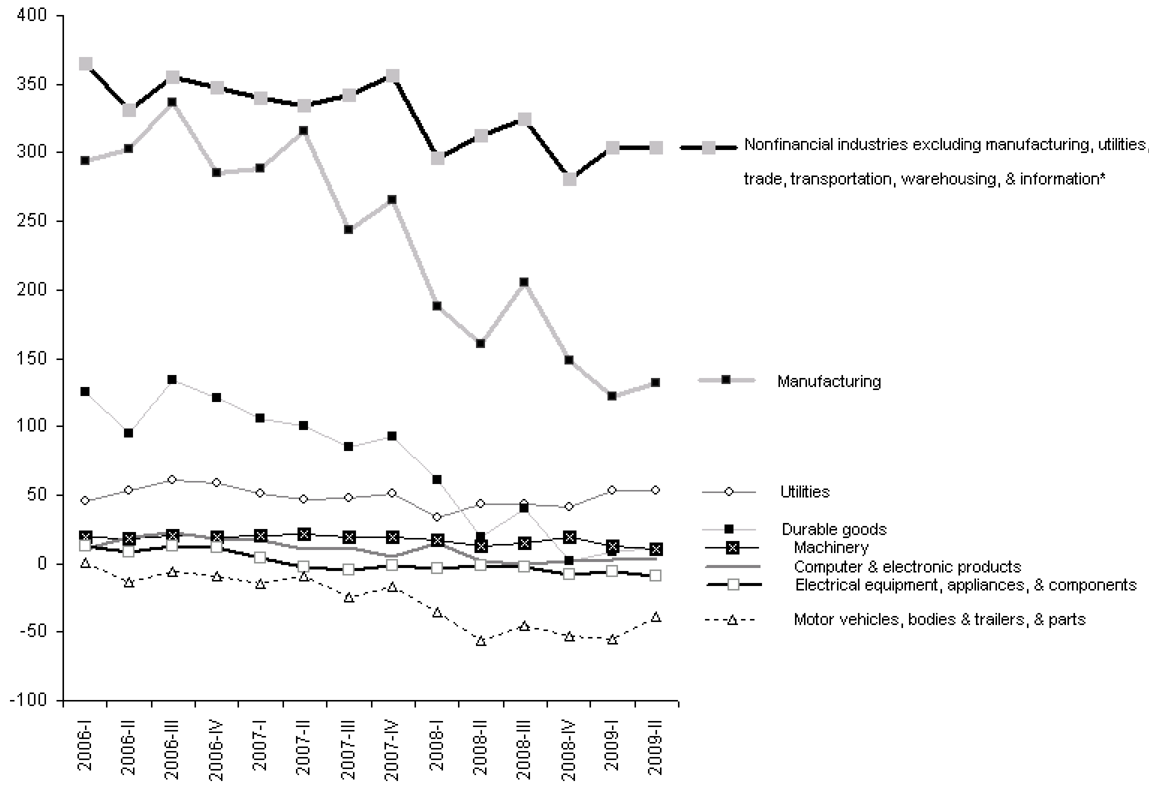
The rise of corporate profits in the U.S. economy since the first quarter of 2009 is an indication that it may be heading out of the recession. However, this assertion should be qualified. *First*, it does not mean that economic conditions are likely to improve in the short run for most people. The reason is that even if economic activity starts expanding again, in the early phases of any recovery, business firms are reluctant to hire workers or make major investments, since they can raise their output by increasing the use of their existing labor and machinery, which has not been working to their full capacity during the recession. Therefore, they can increase their business activity with little or no investment in extra equipment or hands. As a result, unemployment can continue at high levels for many months, a year, or more after the economy is expanding again. *Second*, a more accurate assessment of the economic prospects in 2010 requires a close examination of the sources of profits and the specific conditions of the major components of the economy. The fact that financial sector profits multiplied by nearly a factor of 3 (from $121.9 to $363.3 billion) from the third quarter of 2008 to the third quarter of 2009, while profits of non-financial industries barely grew (from $669.4 to $671.9 billion, see figure 2) in the same period make the strength of any recovery in the U.S. economy very uncertain. Moreover, as figure 3 illustrates, the major components of manufacturing and the real economy in general have had flat or decreasing profits in the last three years.

Figure 2. Total corporate profits, in billions, and its distribution among the non-financial and financial industries of the domestic economy since 2006



Source: NIPA data, as in figure 1.

Figure 3. Corporate profits in selected sectors of the U.S. economy.†



Source: NIPA data as in figure 1.
† Note that for the sector of motor vehicles manufacturing the curve is below the zero level, meaning sustained negative profits, i.e., loses, in this sector.

* The category of nonfinancial industries includes agriculture, forestry, fishing, and hunting; mining; construction; real estate sales, rental, and leasing; professional, scientific, and technical services; administrative and waste management services; educational services; health care and social assistance; arts, entertainment, and recreation; accommodation and food services; and other services, except government.

Tax breaks for buying homes and the "cash-for-clunkers" program, which gave qualifying U.S. consumers who bought new cars in 2009 deep discounts paid for by taxpayer funded rebates, significantly boosted flagging sales in two important parts of the U.S. economy. But both the tax breaks for purchasing houses and the cash-for-clunkers program were only temporary emergency measures. With levels of mortgage delinquency reaching record levels, the expectation as of this writing in late January 2010 is a further decline in house prices,[37] which are likely to continue throughout 2010. That would significantly undermine any economic recovery.

Though the financial sector has been the only one in which profits have clearly risen during 2009, that does not mean it is in good shape. In the first eleven months of 2009, the Federal Deposit Insurance Corporation, the publicly administered insurance fund that

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[37] David Streitfeld, "U.S. Mortgage Delinquencies Reach a Record High," *The New York Times*, November 19, 2009, online at: http://www.nytimes.com/2009/11/20/business/20mortgage.html?ref=patrick.net.

protects depositors, seized and sold 124 banks, and analysts expect hundreds more to collapse in the months ahead. Indeed, FDIC insurance funds fell into the red for the first time since the savings-and-loan crisis of the early 1990s. Troubles in the banking sector imply tight conditions for credit, and according to FDIC chairwoman Sheila C. Bair, adverse conditions in credit markets are expected to continue for "a couple of more quarters before we see a meaningful improvement in that trend."[38]

With credit markets partially frozen, the real estate markets precarious and likely deteriorating further, domestic consumer demand stagnant, and the rest of the world in similar conditions, which negates the likelihood of any foreign stimulus for the American economy, the prospects of recovery during 2010 are highly uncertain. Instead, a short recovery followed by another downturn could very well materialize. Furthermore, emerging monetary disturbances due to fiscal deficits and the loss of purchasing power of the U.S. dollar could appear at any time, worsening the situation. Therefore, it is not surprising that serious Keynesians like Paul Krugman are concerned about the soundness of the economy and continue to call for a new dose of fiscal stimulus.[39]

Regardless of economic performance in 2010, there are lessons to learn from almost two centuries of business cycles, which have thus far shown that the harder the fall, the bigger the bounce. That is, the longer the downturn, the more failed businesses and the more people unemployed and ready to work for much less than they earned previously, the more favorable the prospects for profit and thus the conditions for successful investment that typically lead to economic expansion. By sustaining failing corporations, creating business activity by fiscal policy, and providing some relief to the needy, the government is ameliorating the social impact of the recession while at the same time limiting the factors that make recessions evolve by themselves into expansions. On the other hand, we now have documentation that periods of strong economic growth escalates environmental destruction, which is resulting in the deterioration in the health of the population, an impact that is wreaking havoc globally as the ecological crisis worsens.[40] Whether politicians and economists will take this evidence into consideration to moderate their normal recommendation of economic growth at any cost is still to be seen.

Though the 1950s and the 1960s were the time of the Korean War, the Vietnam War, and the escalation of the nuclear race of the Cold War that put humanity at risk of a Third World War, these years are considered the Golden Age of the American economy, because they were decades of stable economic growth and increasing income and prosperity. Many economists came to think that avoiding boom-and-bust cycles was possible with the

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[38] Eric Dash, "As Bank Failures Rise, F.D.I.C. Fund Falls Into Red," *The New York Times*, November 24, 2009.
[39] Paul Krugman, "The Jobs Imperative," *The New York Times*, November 29, 2009, online at: http://www.nytimes.com/2009/11/30/opinion/30krugman.html.
[40] See for instance U.G. Gerdtham and C. Ruhm, "Deaths Rise in Good Economic Times: Evidence From the OECD," *Economics & Human Biology*, Vol. 4, No. 4, 2006, pp. 298-316; J.A. Tapia Granados and A.V. Diez Roux, "Life and Death During the Great Depression," *Proceedings of the National Academy of Sciences*, Vol. 106, 2009, pp. 17290-17295; J.A. Tapia Granados, et al., "A Threatening Link Between World Economic Growth and Atmospheric CO_2 Concentrations," online at: http://sitemaker.umich.edu/tapia_granados/files/a_threatening_link_f5___refs.pdf.

tools of Keynesian economics. But the long expansion of the "Golden Age" followed the massive destruction of financial and physical capital during the Great Depression and World War II, and the fast expansion of the 1950s and 1960s eventually led to the turbulent 1970s and 1980s. When the combination of inflation and unemployment pushed Keynesian theory largely out of favor, the discipline of economics splintered into a variety of schools and tendencies. Mainstream economics, however, proclaimed the rationality of expectations and markets and the irrelevance or inappropriateness of regulations. Eventually new myths like the "New Economy" and the "Great Moderation" emerged to deny the inherent instability and proneness of the market economy to disruption.

It is often said tongue-in-cheek that forecasts are always risky, particularly about the future. Whether the world economy will start growing again in 2010 or whether the recession that began late in 2007 will become a double-dip recession with economic stagnation for a few more years is still very uncertain. What is not uncertain, however, are the general rules that govern the present economic system—with enterprises competing for sales and looking for money profits, we will have upturns and downturns, we will have financial crises, minor recessions, and major depressions. Capitalism tends to increase social inequality over time, while joblessness fluctuates, sometimes increasing and sometimes decreasing. In the best scenario, economic growth will be more or less sustained, and the social maladies generated by our competitive and predatory economy will be relatively tolerable. However, even the rosiest state of affairs can only be a minor consolation, since "prosperity" and economic growth under the present socioeconomic system are just another name for a process pushing us closer to further calamity, along a spectrum ranging from low-intensity or high-intensity war to minor or major environmental disaster.