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Historical perspectives

Often lacking in mainstream analysis of the contemporary problems of the American economy is a historical context within which to situate current events. While quantitative change is clearly a most important focus for economic investigation, qualitative transformations in the nation's economic life also figure prominently in aggregate performance. For this reason, it is necessary to situate within analytic studies of recent economic difficulties in the United States a sharply focused awareness of long-term historical forces that have molded both the causes of and the reaction to contemporary economic decline.

The two essays in this part seek to provide this historical sensibility. Michael A. Bernstein provides a broad outline of American economic history in the late twentieth century. David M. Gordon offers a systematic look at the declining fortunes of the American economy in the postwar era.

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1

Understanding American economic decline: the contours of the late-twentieth-century experience

MICHAEL A. BERNSTEIN

> [W]e have been witnessing not merely a depression and a bad recovery . . . but the symptoms of a permanent loss of vitality which must be expected to go on and to supply the dominating theme for the remaining movements of the capitalist symphony . . .
>
> –Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Row, 1962), 111

I. INTRODUCTION

Will a "permanent loss of vitality" be the defining characteristic of the economic history of late-twentieth-century America? Not very long ago, during the Great Depression of the 1930s, many economic experts had wondered if capitalism would survive at all. Today many of them fear that the American economy is weak and failing, destined to be a second-echelon participant in a new twenty-first-century world economic order. That sense of foreboding is shared by the public. Most Americans, at least of the lower and middle classes, believe that their children will not sustain a standard of living equal to their own.

After World War II, the views of those who had argued that the Great Depression was symptomatic of a profound weakness in the mechanisms of capitalism appeared hysterical and exaggerated. As the industrialized nations sustained dramatic rates of growth during the 1950s, the economics profession itself became increasingly preoccupied with the development of Keynesian theory and the management of the mixed economy. The presumption was that the Great Depression could never be repeated owing to the increasing sophistication of economic analysis and policy formulation. Indeed, the belief became commonplace that the business cycle was "tamed" and "obsolete."

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The erratic performance of the American economy in the past three decades has eroded this notion. Serious questions have been raised concerning political obstacles to the management of cyclical instability and our ability to diagnose and correct economic maladies. The confidence of the Keynesian Revolution has been shaken.

Even so, our current anxieties are not paralleled by a firm conviction as to what intellectual strategies would be most fruitful in the formulation of effective public policy. Mainstream economic theory remains wedded to an analytical framework that eschews close attention to historical and institutional parameters. This persistent aversion to long-term and institutional theories of economic instability and crisis stems in large part from the methodological predilections of contemporary economists. Secular and institutional mechanisms are exceedingly difficult to model and therefore to subject to modern hypothesis testing. They are also not directly studied by means of partial or general equilibrium argument. The ever-increasing role of economists in government and in the private sector has turned attention away from the study of historical events and processes toward the investigation of contemporary policy formulation and execution. In the context of economic history, this development has substituted arguments concerning what should have been done by the appropriate authorities for analysis of what actually happened and why. In the literature on economic instability itself, earlier questions regarding the causes of fluctuations have been discarded in order to examine what should be done once cycles begin.

Regardless of the prejudices or tendencies of contemporary economic analysis, the inadequate performance of the American economy since the early 1970s has brought the question of long-term and institutional change back to the fore. Debates concerning so-called reindustrialization and industrial policy have become more common and intense. The disruptive impacts of industrial life cycles and the emergence of revitalized foreign competition in several major industries have garnered increasing attention from American economists and political scientists. In this context, it is imperative that we reassess our analytical understanding of business cycles and macroeconomic instability, as well as our grasp of the twentieth-century evolution of the American economy as a whole. By doing so, we may not only win a better appreciation of the challenges we face in our efforts to rectify the shortcomings of the American economy; we should also become more aware of the distinctive and altogether novel

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ways in which American prosperity had been achieved in the immediate post–World War II era.

II. THEORIES OF ECONOMIC INSTABILITY

A. Basic theory

Any conception of economic instability or of cycles in economic performance must explain how, over time, markets fail to provide for balanced growth. Persistent or intermittent unemployment of labor or capital are symptomatic of some difficulty in reaching what economists call equilibrium. In a capitalist economy characterized by a fair degree of competition in major markets, unemployment (or inflationary overemployment) of any resource should generate price changes that will serve to eliminate the distortion and "clear" the market in question. This equilibrating mechanism of modern markets may generate periodic swings in economic performance known as business or trade cycles. Obstacles to such equilibration may lead to sustained periods of instability or depressions.

If one were to imagine a simple economy in which one sector made consumption goods and another capital goods, given a particular endowment of resources and technology with a fixed population of given demographic characteristics, balanced performance would involve a virtual steady state in which the output of both sectors would be totally utilized in each production period. There would be no unemployment, of either human or produced inputs, and a simple reproduction of economic life from period to period would ensue. But the assumptions embedded in this exercise – two-sector production, fixed technological and resource endowments, fixed population, and so on – belie the argument. Economies, at least capitalist ones, do not exhibit such constancy. It is this variability in the conditions affecting economic life that is the source of instability.

As population growth changes, as technological know-how is altered, as the composition and interaction of economic sectors is transformed, the ingredients of the growth process similarly change. Moreover, given the decentralized nature of decision making among households and firms in a capitalist economy, fluctuations in economic activity may emerge simply out of recurrent inconsistencies in coordination among various and numerous activities. In all these regards, cyclical volatility as well as

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long-term swings in economic growth are inherent in the workings of capitalist economies.

Some economic theorists as well as economic historians have tried to discern three general patterns in the cyclical performance of modern economies. Periodic waves of fifty years or more were examined by the Russian statistician N. D. Kondratieff in the 1930s. He argued that these "long waves" were associated with the introduction and dispersion of major inventions and dramatic alterations in resource endowments owing to such things as mineral discoveries, transportation and communication breakthroughs, and war. The Juglar cycle, a wave of approximately ten years' duration, appeared to be linked with population movements. A swing of about forty months' length, dubbed the Kitchin wave, was understood to have the appearance of a typical inventory cycle.

Simon Kuznets, Moses Abramovitz, and Richard Easterlin were successful in documenting the existence of waves of some fifteen to twenty years in length in the U.S. case. Such swings, according to these investigators, demonstrated that in the United States and other industrialized countries, economic growth throughout the nineteenth and twentieth centuries proceeded on the basis of intermittent accelerations in output growth and resource utilization. Perhaps most striking, such periods of acceleration were usually followed by serious downturns in economic activity. It seemed clear that these oscillations involved changes in resource endowments (including the size and age composition of the population) and alterations in the intensity of resource use.

Whether of the secular or short-run sort, business cycles embody one of the central puzzles of modern economic life. Sustained (that is to say, uninterrupted) economic growth requires continuing increases in investment expenditures that are large enough to make additions to productive capacity, create jobs, and expand output. Yet, in the absence of technical change, the rate of net investment will fall to zero as soon as the rate of increase in consumption (and hence in sales revenue) levels off. For consumption expenditures to rise consistently, there must be net investment to create jobs and maintain consumer income levels, or injections of spending from elsewhere in the economy such as the government, foreign trade, and from major resource discoveries or territorial expansion. This is an essential paradox of capitalist growth and the reason why growth often takes the form of accelerations and pauses (or "booms" and "busts"). Indeed, the foundation of the mathematical theory of business

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cycles is found in what is known as the "accelerator model" of investment behavior.

The acceleration principle, as it is sometimes known, is premised on the idea that an economy's capital stock (inventory, machinery, tools, and the like) will grow when the level of output is growing. As sales for a firm increase, and thus as inventories run down and capacity is utilized at higher rates, there will be an incentive to invest in more plant and equipment, and to hire more labor to increase production and meet greater demand for a firm's product. But when sales cease to grow, or start growing at a slower rate, net investment will fall to zero as firms seek to adjust to new economic circumstances. A reduction in the rate at which new capacity is purchased, and at which new jobs are thus created, will lead to a falling off in economic activity, or a recession. A recovery, at least in theory, will occur when the ratio between sales and capital stock rises (owing to the reduction in capital occasioned by disinvestment in the downturn) to a point where firms think it appropriate to resume net investment. Two essential concepts emerge from this fundamental characterization of the trade cycle. It is assumed that businesspeople will seek to maintain some target ratio between the level of sales and the size of their capital stock. Furthermore, and as a consequence of this plausible behavioral assumption, sales must rise at a sufficient rate simply to keep investment level, let alone to stimulate net investment. In other words, fluctuations in consumption in capitalist economies generate undulations in investment behavior that lie behind the trade cycle. But investment itself largely determines the level of and rate of growth in consumption due to its impact on job creation and employment. Cyclical instability is, therefore, an essential and unavoidable characteristic of capitalist enterprise.

B. Circulation crises and financial panics

Counterposed to the intermittent volatility of the real economy are perturbations in the monetary and financial system. These too can cause wide gyrations in output and employment and can even, at times, lead to general interruptions of economic activity often called, in the course of American history, "panics." What distinguishes circulation crises and financial panics from so-called real business cycles is that they have often emerged independent of movements in inventory, population growth, technical change, and the like. Their propagation appears linked, in many

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cases, with institutional and regulatory constraints on the financial and banking sectors of the economy.

A financial crisis, in its simplest form, can emerge if there is an inadequate supply of currency in the system. If a national money supply is tied to the availability of a particular precious metal such as gold or silver, fluctuations in the supply of that medium will cause changes in national output. A rapidly growing money supply will, all other things remaining the same, initiate an inflationary boom as greater amounts of dollars "chase" a given output of goods and services. Conversely, should the money supply shrink, a deflationary spiral will ensue with concomitant impacts upon output, employment, and investment. Obviously, changes in the growth rate of the money supply can occur even in a paper money system in which a central monetary authority or political events alter that growth rate over time.

In a decentralized banking system, with a hard money (i.e., precious metal) base, the potential for financial disruption is great. There exist no unambiguous lines of authority in the event that a particular region or urban area suddenly requires an increase in circulating medium. Similarly, should some banks fail, owing to a deterioration in general economic conditions, poor management, or sheer bad luck, a decentralized institutional system of finance offers no mechanism by which liquidity can be restored. As banks close their doors, firms must cease operations and lay off workers; households will need to cut back consumption expenditures or substitute nonmonetary forms of exchange in their daily activities. An economic convulsion is the result.

Interestingly enough, circulation problems arising out of decentralized or hard money systems may have their genesis simply in the seasonal fluctuation of economic activity. In an agricultural economy at harvest time, for example, farmers will accumulate large cash reserves as they sell their crops. At the same time, merchants, shippers, and packers will require loans in order to process and move farm crops to market. Often such agents are located in cities or metropolitan areas distinct from the farm belts they serve. If there is no clear channel by which farmers' cash reserves can be recycled to those banks financing the wholesale trade, an interruption in commerce will result.

Financial panics may also occur when and if depositors lose confidence in the security of their bank-held assets. Fractional-reserve banking, and its unique profitability and ability to stimulate economic growth, is premised on the notion that every demand deposit will not be drawn

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upon at once. Yet if depositors sense some difficulty in the robustness of the banking system, a "run" can develop in which all deposits are in fact drawn down at the same time. In the face of such an onslaught, individual banks have little choice but to lock out their customers. Of course, as one bank pursues this strategy, the ingredients of wholesale panic are further supplied. Such inherent fragility in the private banking system can only be compensated for by governmental institutions that establish lenders of last resort, in the form of a central or national bank, or insurance systems by which the value of all deposits is secured to some minimum. Once again, even with respect to the monetary circulation and financial mechanisms of modern economy, the possibility of crisis and volatility is ever present.

C. *Effective demand failures*

Shortfalls in national output may also occur due to reductions in the level of demand. As consumption falls and firm sales are reduced, a cumulative downturn may develop whereby reductions in demand cause a decrease in investment and employment which itself furthers the decline in consumption as workers lose income. It is even possible that an economy may gravitate toward an "equilibrium" position, that is, a state of affairs from which there seems no tendency to depart, in which significant amounts of capital and labor are unemployed. This deviation of actual from potential output may be the result of distortions in the price mechanism, by which adjustments in wages and prices that might bring about full employment of resources are obstructed, or due to misperceptions on the part of wealth holders and workers as to the economic alternatives available to them. Capital might be hoarded, rather than productively invested, owing to a lack of confidence; labor might be withdrawn from the market in the (mistaken) impression that wages will rise in the near future. Virtual economic stagnation can be the ultimate result.

Tendencies toward underconsumption (or its mirror image, overproduction) may be derived from short-term changes in the distribution of income or long-run transformations in the structures of capital accumulation. Downward inflexibility of prices, caused by the concentrated structure of industry or the impact of labor unions, may intensify the effective demand problem and prevent the price system from reaching a new equilibrium at full employment. On the one side, "sticky prices" limit the already constrained purchasing power of consumers. On the

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other, to the extent that noncompetitive pricing predominates in the capital goods sector, producers are less willing to buy new plant and equipment. High real wages, held up by union pressure or government policy, may further contribute to persistent disequilibrium in labor markets. Yet lowering wages in an economy with highly concentrated and thereby imperfect markets can result in a reduction in real wages as prices remain high. The effective demand crisis is thereby exacerbated. Only if price adjustments are general, economy-wide, and followed rapidly by increased investment can a deflationary recovery process succeed.

Price inflexibility that is an outgrowth of capital concentration and imperfections in markets has especially negative implications for economic performance in the intermediate to long run. In highly concentrated industries, a downturn in the business cycle may result in perverse reactions that make the slump worse. The net revenue of firms with a great deal of market power may be so attenuated in a slump that strategies of price reduction may be viewed as unfeasible. There may even be incentives to raise prices in order to compensate for the reduction in the volume of sales.

If price reductions do not occur when the economy-wide rate of growth declines, the necessary adjustment of sectoral rates of expansion to the aggregate rate requires reductions in individual firms' rates of capacity utilization. If industrial structure were more competitive, however, excess capacity would not result from a decline in the rate of growth; rather, prices would fall. Reductions in capacity utilization imply not only lower national income but also higher unemployment. In the presence of underutilized capacity, firms will be disinclined to undertake net investment. A cumulative process will thereby be established wherein a decline in the rate of growth, by generating reductions in the rate of capacity utilization, lead to a further decline in the rate of expansion as net investment is reduced. Individual firms, believing that decreases in investment might alleviate their own burden of excess capacity, merely intensify the problem economy-wide. It is this "fallacy of composition," assuming that what is good for the individual is good for the whole, that is the basis of most macroeconomic difficulties in capitalist systems.

Effective demand failures may also be generated by declines in the rate of population growth or reductions in the rate at which innovations and new technologies are introduced into the economic system. As population growth falls off (assuming some minimum level of affluence of the population as a whole), the growth of major markets such as housing,

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transportation, and food production also slackens. Economic growth is thereby jeopardized and may only be resumed by the introduction of new technologies and products that can absorb larger investment outlays to expand production and employment once again. If these are not forthcoming, the only solution may be some form of exogenous spending (such as governmental deficit spending) to augment consumer purchasing power.

It is also possible that in more affluent societies, an ever-increasing volume of savings is generated. Such savings may eventually find no outlets except at unrealistically low rates of interest – rates at which investors may prefer to hold their wealth in cash rather than securities, bonds, or other titles to real capital. This would constitute a monetary parallel to the real problem of a potentially vanishing set of investment and technological opportunities. In other words, at very low rates of interest, the demand for money becomes so high as to create a "liquidity trap." As money accumulates in cash hoards, the decline in productive spending makes the downturn worse. As one distinguished macroeconomic theorist, Michal Kalecki, once put it: "Capitalists get what they spend; workers spend what they get." If either workers' consumption spending or capitalists' investment outlays decline, recession or depression is the result.

D. Compositional and structural distortions

Persistent unemployment, lagging capacity utilization in major industries, and inadequate rates of net investment in a national economy may also be the outgrowth of transformations in the composition of national product. Simple accelerator models of the business cycle fail to capture this complexity of modern economies because functional relationships between sales and investment obscure the influence of secular changes in the mix of industries constituting the national aggregate. Long-range prospects for expansion underlie the decision making associated with large investment obligations. The size and rate of growth of the relevant market are of primary concern. To the extent that firms in an industry during the trough phase of a business cycle have pessimistic expectations regarding their markets, a revival becomes dependent on either the creation of wholly new, promising markets (i.e., products) or the stimulus of new expenditures arising outside the industry. Highly concentrated sectors bolster the potential for economic stagnation. The reluctance to compete

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