HM3: the profits-investment puzzle

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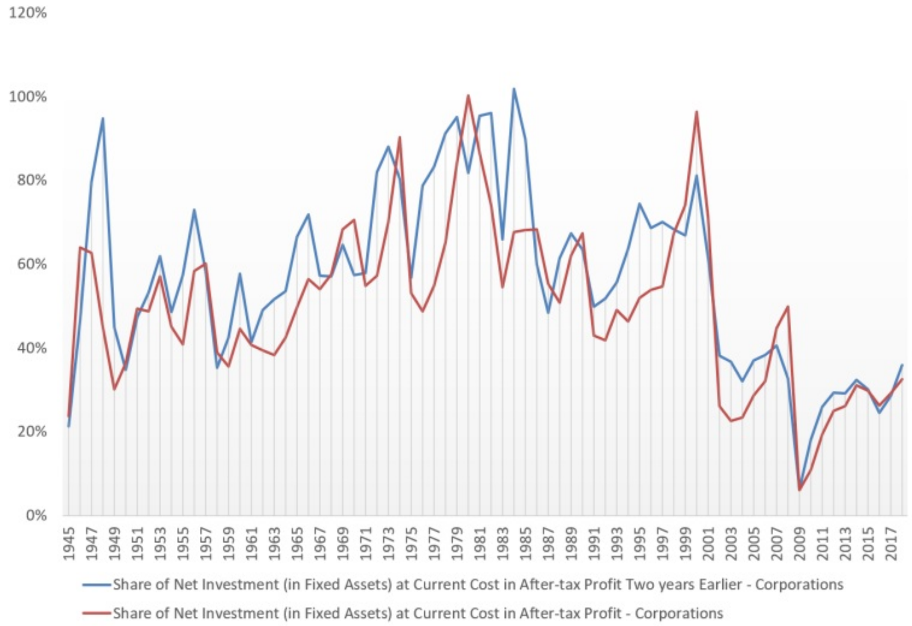
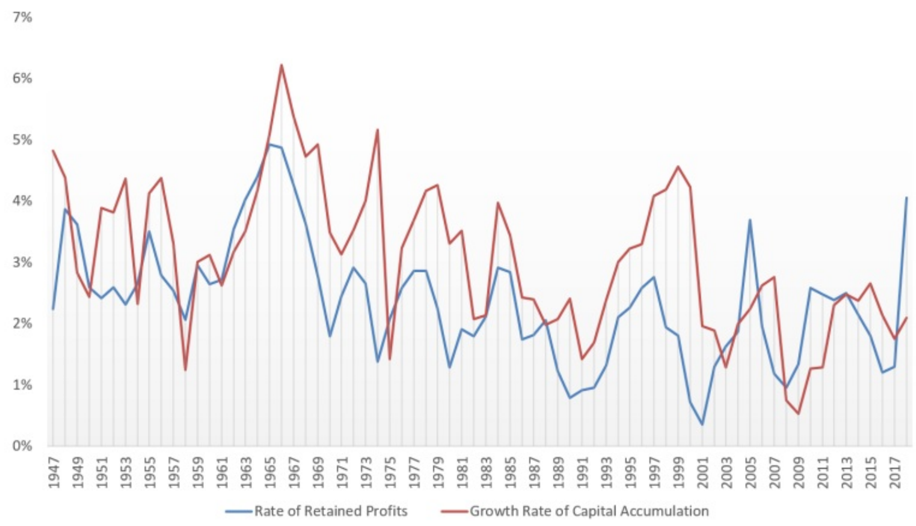
Michael Roberts, November 16, 2019

The other session at the Historical Materialism London conference that I participated in was on The Relation between Profits, Investment and Crises. This was organised by Al Campbell from the University of Utah. In his paper, Al outlined how in the last two decades a gap opened up between the growth in profitability and the rate of investment and accumulation (Al Campbell). Al showed that the share of investment in total US profits fell from the early 2000s until the Great Recession and still stands well below the average share in the 1980s and 1990s.



So what was going on after 2000? Al strips out profits that were distributed as dividends to shareholders and interest to lenders and bond holders to expose retained earnings and finds that *"the answer (and it is an answer as far as it goes) – the amount of real investment tracks retained profits. Retained profits have fallen as a share of profits, and so real investment has fallen correspondingly."*

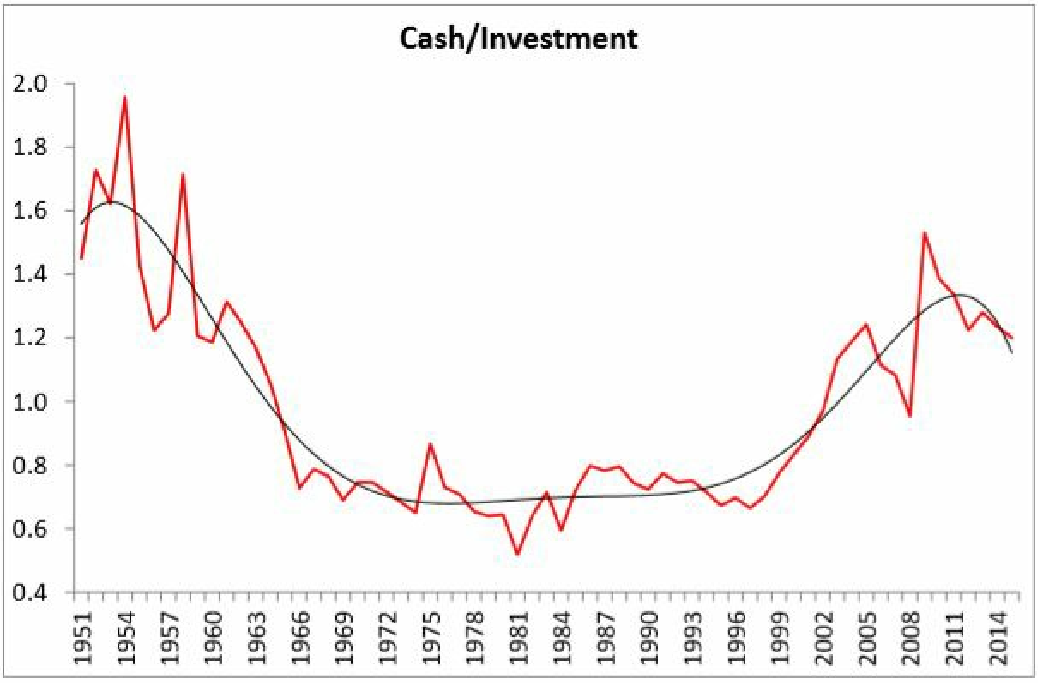


But why has there been such a reduction in retained profits for productive investment and an increase in the share of profits going in dividends and interest? And what do the shareholders and bondholders do with their share? Do they spend it (capitalist consumption) or do they save it (in cash) or do they re-invest it (financial assets)?

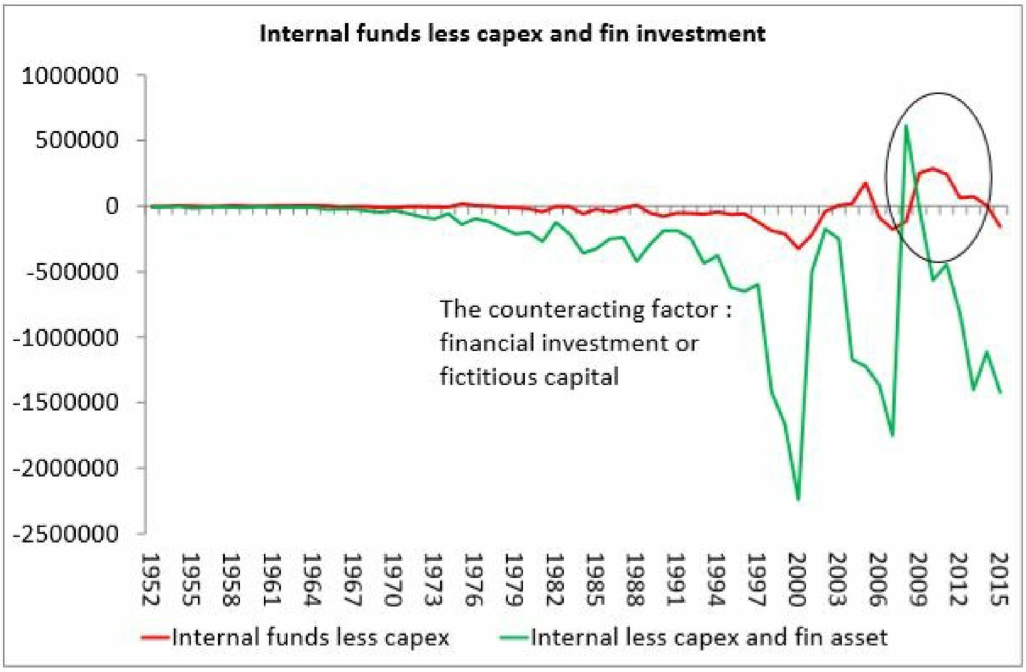
From the data, Al reckons the reduction in the share of retained profits is not because interest costs have risen (interest rates are at all-time lows) or because companies pay more to shareholders. More likely, it is because the profitability of productive investment has stayed low so there is an 'over-investment' of productive capital and the unused profits are either hoarded as cash by companies, or distributed in increased dividends and more recently used in huge share buyback programmes to drive up the prices of company stock.

Al asked the question: is there empirical evidence to explain this profit-investment gap? Well, I think there is some. I raised the same puzzle in a paper to HM London 2016, The Great Recession: a Marx not a Minsky moment. (Marx not Minsky) This is what I said then: *"Usually, US corporations have invested more than they had available in corporate savings. The only period that this was not the case is 2000-07. But note, corporate savings between 2000-7 did not grow faster (5.3% pa) than in other periods. What happened was that capex grew much more slowly (4.0%). That suggests that corporate savings were switched into financial rather than productive investment."*

There clearly is some cash hoarding. But this hoarding was concentrated in the large tech companies, which either kept this cash abroad to avoid tax and/or increased bond issuance on the back of these assets. At the start of the credit crisis in 2007, companies with more than $2.5bn each in cash and near cash items, such as short-term investments, held 76 per cent of the $1.98tn of cash reserves of the non-financial members of the S&P 1200. By the third quarter of 2013, this had risen to 82 per cent (of a total $2.8tn), the highest percentage since before 2000. Of non-financial companies in the S&P Global 1200 index, just 8.4 per cent hold 50 per cent of the cash. Indeed, 40% of companies actually reduced their cash balances. Most small to medium size have no cash piles. Indeed, as I showed in that 2016 paper, cash as a share of total corporate financial assets is not particularly high historically.

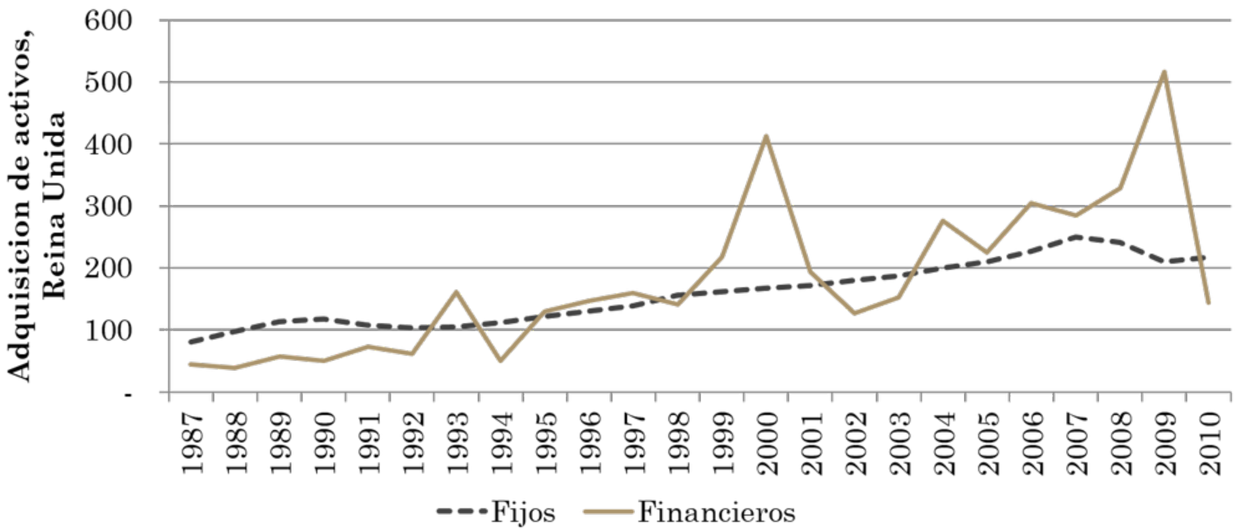


The switch is from productive assets to financial assets. I found in the 2016 paper, that there appears to be a surplus of corporate savings over investment in capex from about 2000 (red line in graph below). However, when you add in financial asset investment (green line), there is a huge deficit (net borrowing), which takes off at the end of the 1990s. So non-financial companies increasingly borrowed to speculate (often in their own shares) and not invest productively.



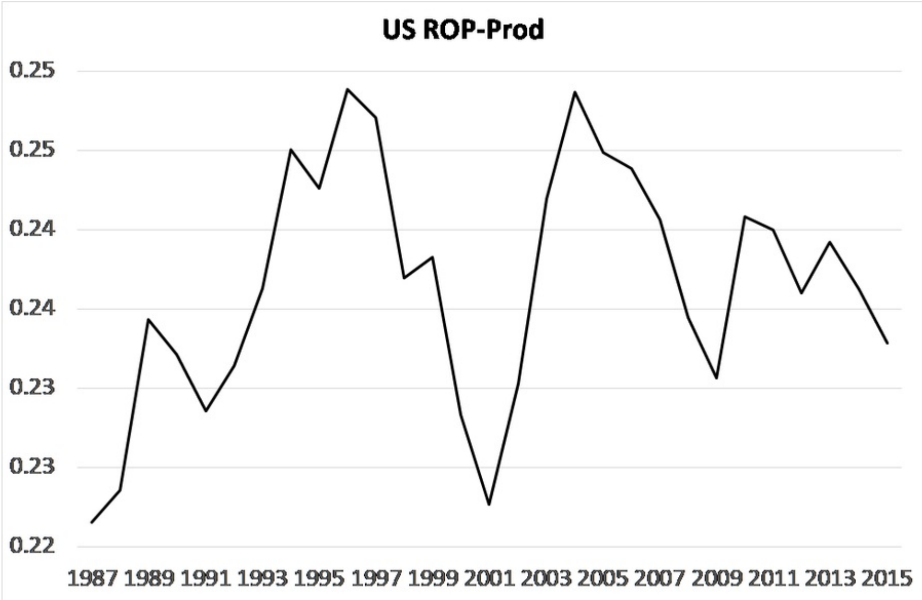
Alan Freeman, a leading Marxist economist, attempts to answer the same question in a new paper.
Rate_of_profit_investment_and_the_causes (1)
Alan poses: *"If American and British companies only invest the minority of their surplus, what do they do with the rest? Do they keep it in the form of money – a classic form of crisis? Do*

they invest it abroad – a classic form of imperialism; Do they invest it in financial assets – ie saleable monetary instruments?" Freeman reckons it must be a combination of all those. But *"in any case, they don't use it to boost new production*." Here Freeman shows that rise in the purchase of US financial assets compared to productive assets.



Freeman suggests that there has been a switch to holding financial assets (shares and bonds) rather than investing in productive assets because *"the lower the productive rate (of profit), the larger the proportion that remains in the form of currency or financial assets."* And Alan goes on to show that rates of profit in Europe, the US and Japan have continued to fall if you include financial assets.

In a recent post, I too made similar points and offered up some empirical work from other scholars on this puzzle. Also, I have recently used the KLEMS database to calculate the profitability of the US productive sector. Between 1987 and 1997, the profitability of the productive sector rose 12%, then fell sharply, provoking the mini-recession of 2001. Profitability then recovered to previous levels by 2004. But then four years of decline led into the Great Recession. The recovery in profitability after the slump of 2008-9 was weak and started to fall as early as 2011. This can explain the weak investment in productive activities in the period after 2009 that I call the Long Depression.

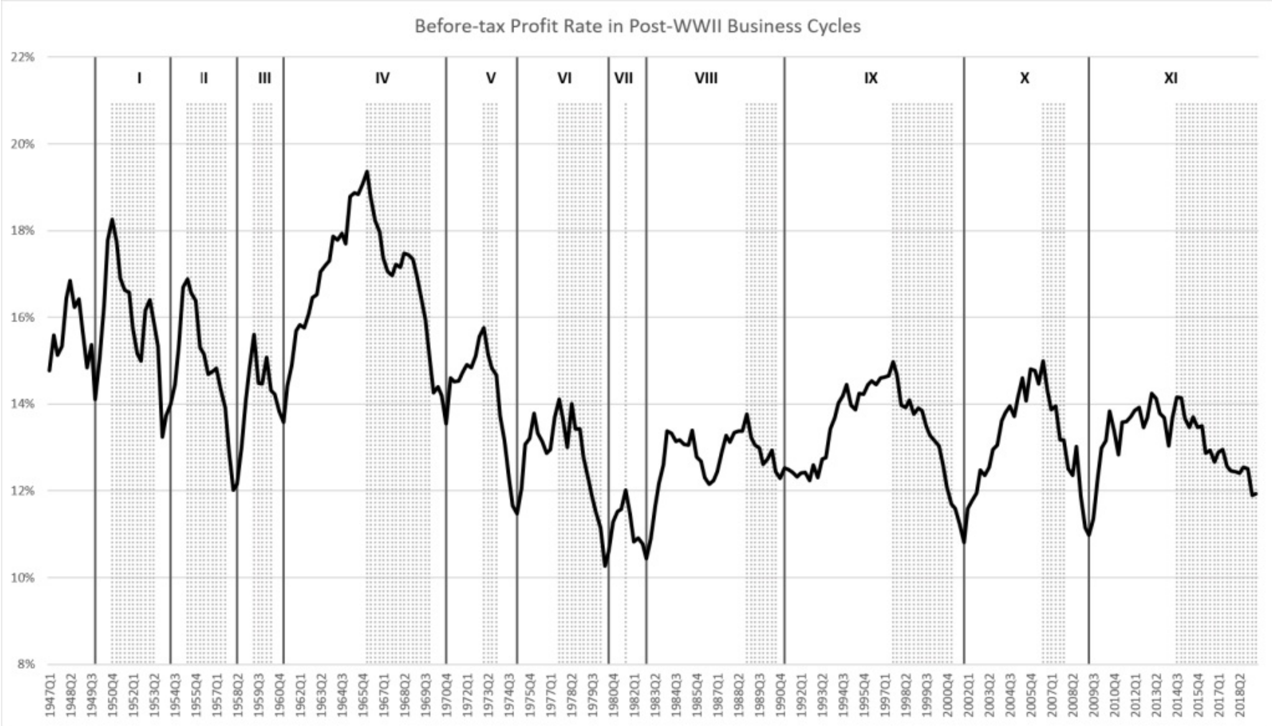


I have argued on this blog that the profitability of capital is key to gauging whether the capitalist economy is in a healthy state or not. If profitability persistently falls, then eventually the growth in the mass of profits will slow and even fall absolutely and that is the trigger for a collapse in investment and a slump. This was the basis of my own paper in this session, on the Profits-Investment nexus. Profits-Investment Nexus

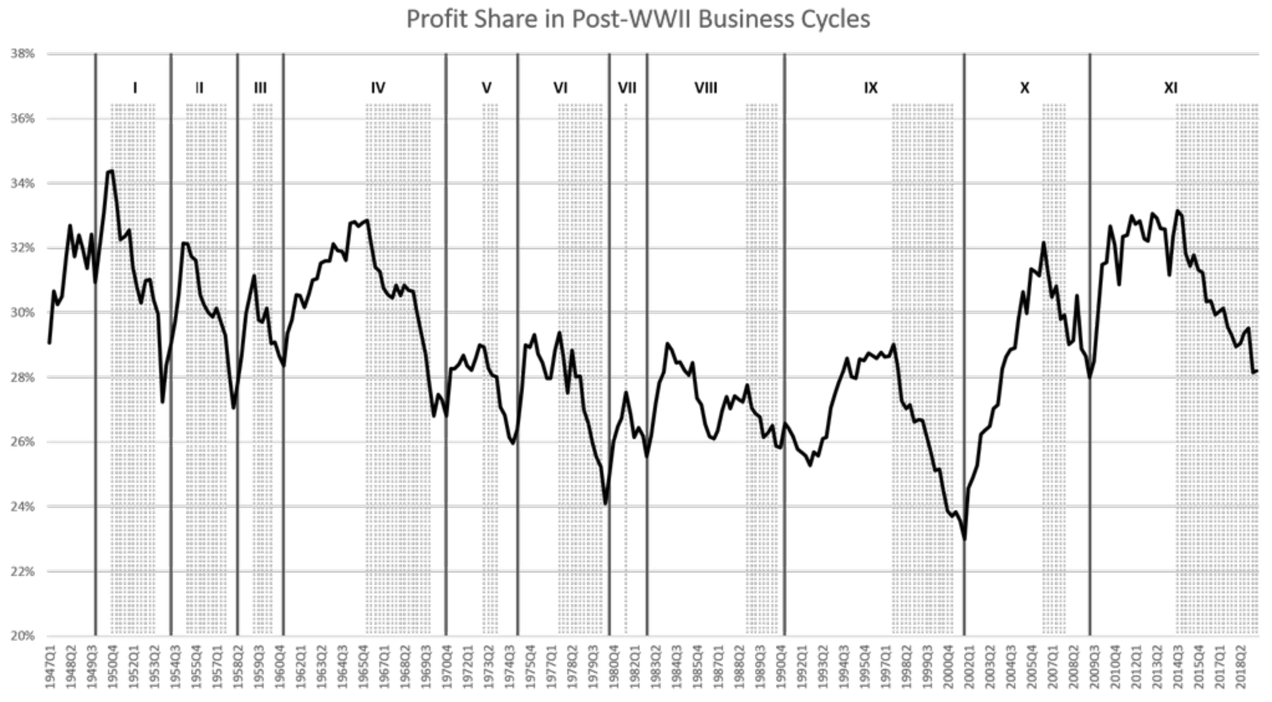
In my view, the Marxian theory of crises is based on the movement of business investment. A fall in investment, not consumption, is the swing factor in generating a crisis of overproduction and a slump. Keynesians and post-Keynesians might (partially) agree. But they think that business investment decisions depend on 'uncertainty', 'confidence' or so-called 'animal spirits'.

In contrast, Marx starts his analysis of capitalism with the discovery of surplus value through the exploitation of labour. Profit is thus the driving force of capitalist accumulation. What drives business investment is profitability, profits and the expectation of profits, not 'animal spirits'. And what the profit-investment puzzle of the last two decades reveals is that it is the rate of profit in productive investment that matters. If it is low or is falling, then capital switches abroad, or hoards cash or invests in financial assets (what Marx called fictitious capital). If companies borrow to do so, then a credit bubble inflates, which bursts when profits in productive assets fall.

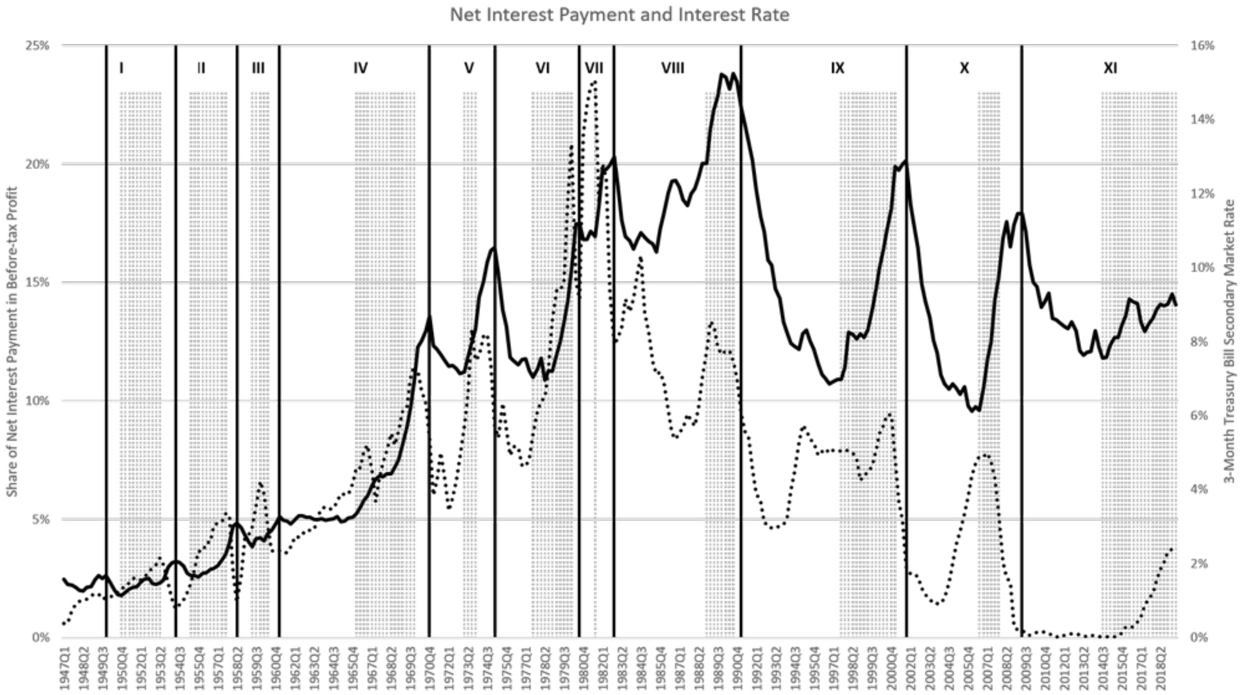
In the session, Bucknell University's Erdogan Bakir provided powerful support for this theory of crises. (erdogan bakir) As Erdogan says in his paper: *"Marx theorizes the increasing fragility, vulnerability or sensitivity of the contract-credit system in the mature expansion. As the expansion overheats, the ability to fulfill contractual obligations will be increasingly threatened by any significant decline in the gross rate of profit."* Bakir identifies a profit cycle where profitability rises, then Marx's law of the tendency of the rate of profit to fall kicks in, and profitability falls back. He identifies 11 such cycles in the US post-war economy.



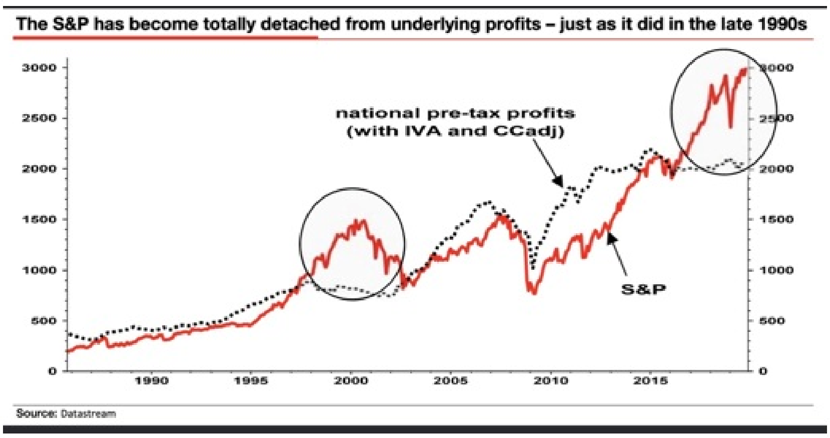
Eventually, the *share* of profit in total output falls, creating the conditions for a slump in investment and production. So it goes from the rate to the mass (this follows closely my thesis presented in the debate with Professor David Harvey at this year's HM – see my post on HM1).



In the boom part of the cycle, production and investment rise and interest rates are low to encourage credit. But in the later part of that cycle, interest rates rise, corporate debt reaches highs and profitability starts to fall. Thus, there is a scissor effect on capitalist investment.



The current cycle since 2009 has been the longest post-war cycle in the US and profitability has fallen since 2014, the longest period of decline. The US economy is now in its late part of the current cycle. But meanwhile, the stock market booms – way out of line with corporate profits. Another recession is overdue.



What this HM session suggested is that the next recession has been delayed because of the unprecedented expansion of fictitious capital since 2000 as central banks push down interest rates to zero and implemented huge injections of money into the banks. Companies have relied on fictitious profits from rising share and bond prices while profitability in productive investment (even overseas) remained low and falling. But this contradiction cannot last, if Erdogan Bakir's thesis of the profit cycle holds.

Every year, HM hears an address from the winner of the Deutscher Memorial prize *"for a book which exemplifies the best and most innovative new writing in or about the Marxist tradition".* Last year, the winner was Kohei Saito, associate professor of political economy at Osaka University, for his book on Karl Marx's Ecosocialism: Capital,Nature and the Unfinished Critique of Political Economy. I missed his address but I'll try and review that book in the near future. This year's winner, announced after the conference, was Brett

Christophers from Uppsala University, Sweden with his book, The New Enclosure: The Appropriation of Public Land in Neoliberal Britain. Again, I shall try and review that book soon.

Finally, there were many other sessions at HM on all sorts of subjects and issues, including others on Marxist political economy. But I had no time to attend these. The three posts on HM are the best that I could do.