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# 'Financialisation' and the Tendency to Stagnation

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Beginning with the failure of two Bear Stearns hedge funds and the consequent freezing of the high-risk collateralised debt obligations market in June 2007, the financial crisis deepened in 2008, and at the time of writing in April 2009, the wheels of finance are yet to start turning again even though governments and central banks around the world have taken many measures – “dropping money from helicopters”, metaphorically speaking, into the financial markets, going much further than merely acting as “lenders of last resort”, exercising their “too big to fail” policy, and so on. By all accounts, the financial catastrophe is the worst since the Great Depression, bringing in its wake a severe economic crisis, and it is time to seriously examine its causes and consequences, a challenge the book under review takes up quite admirably.

The feeding of the speculative bubble in the home mortgage market by massive credit expansion, the selling of large amounts of subprime mortgages, the peculiar securitisation of the mortgage loans and the speculative trading of such securities in the global financial markets, the credit rating agencies' fraudulent ratings, the off-balance sheet device of the structured investment vehicle, and role of credit default swap arrangements have, taken together, commanded a fair share of attention among financial analysts. To make sense of this whole host of factors, the authors, John Bellamy Foster and Fred Magdoff place their description of the unfolding of the crisis quite neatly into the basic pattern of speculative bubbles outlined by Charles Kindleberger in *Manias, Panics, and Crashes: A History of Financial Crises* – a novel offering (“displacement”), credit expansion, speculative mania, distress, and crash/panic – and, with the same clarity and wit so characteristic of the “literary economist”.

Going by this, it might be tempting to view the crisis as a direct consequence of

## REVIEW ARTICLE

### **The Great Financial Crisis: Causes and Consequences**

by John Bellamy Foster and Fred Magdoff (*New York: Monthly Review Press; published in India by Cornerstone Publications, Kharagpur, 2009; pp 160, Rs 100.*)

the deregulation of the financial system since the 1970s, especially the cumulative dismantling of Glass-Steagall that was finally buried when the then us President, Bill Clinton signed the Financial Services Modernisation Act in 1999. But this is not a liberal-left account. The authors come from an intellectual tradition (the *Monthly Review* school) that has its origins in Paul Sweezy's synthesis of Marx's political economy with J M Keynes' insights on investment, effective demand,<sup>1</sup> and the structure and behaviour of modern finance, as well as the theory of oligopoly. They locate the roots of the financial bust in the “real” economy and in the underlying accumulation (savings-and-investment) process, both its financial and “real” aspects.

### **Finance to the Fore**

Since the late 1970s, a gravitational shift of economic activity from the production of goods and non-financial services to finance has been underway. One indicator of this process has been the rapid growth since then of the share of financial profits in total corporate profits. Also reflective of this process of “financialisation” is the explosive growth of private debt – household, non-financial, and financial business – as a proportion of gross domestic product, and the piling of layers upon layers of claims with the existence of instruments like options, futures, swaps, and the like, and financial entities like hedge funds and structured investment vehicles. With financialisation, the employment of money capital in the financial markets and in speculation, more generally, to make more money, bypassing the route of commodity

production, increasingly became the name of the game. In Marx's terms, financialisation entailed a shift from the general formula for capital accumulation,  $M-C-M'$ , in which commodities are central to the generation of profits, to one “increasingly geared to the circuit of money capital alone,  $M-M'$ , in which money simply begets more money with no relation to production” (p 133).

The flood of private debt to finance such activity has been sustained by successive booms in asset prices; indeed, such booms have, in turn, been fed by the explosion of debt.<sup>2</sup> As long as the asset price bubble grows, consumers and businesses get access to more credit to buy more home or financial assets because their creditworthiness is determined by the market values of the assets they hold, which act as collateral. The rise of asset values and the intensification of the speculative mania contribute to the growth of borrowing, which, in turn, flames the fires of speculation and the further rise of asset values. On the supply side of the financial markets, in the competitive race to grab the hindmost of the profits in store, a whole array of players get into the act of frenzied “financial innovation”, leading to the multiplication of financial assets of all kinds, for instance, the securitisation of mortgage loans through the collateralised debt obligation, or the credit default swap to speculate on the quality of credit instruments. It is only when the asset price bubble pops and the underlying collateral thus vanishes in thin air that all hell breaks loose across financial institutions and markets, and across countries in this world of globalised finance.

### **Weak Propensity to Invest**

But what brought on the financialisation of the economy in the first place? The us economy entered a period characterised by slow economic growth, high unemployment/underemployment and excess

capacity beginning with the sharp recession of 1974-75 after around 25 years of rapid ascent following the second world war. The inducement needed to generate investment high enough to sustain the vigorous growth of the so-called Golden Age was no longer to be found. But capitalism as a profit-directed system has an imperative to accumulate capital – it cannot stand still; it either expands or it slumps. An important “solution” to the problem of long-term “stagnation” was found in financialisation, which proved functional for capitalism, in that, what growth the economy produced over the period of the 1980s to the present has, to a significant extent, been due to the financial explosion. Speculative finance became “the secondary engine for growth given the weakness in the primary engine, productive investment” (p 18). The system was now “more and more dependent on a series of financial bubbles to keep it going, each one bigger than the last” (p 18).

As the authors themselves give credit to, their analysis leans heavily on Paul Sweezy and Harry Magdoff’s documentation and analysis of developments in the us and world economy in the pages of the *Monthly Review* over a period stretching from the late 1960s to the late 1980s (as also, short perspective articles by Sweezy up to the mid-1990s), a number of these pieces tracing the process of what later came to be called financialisation. The analytical framework of the book draws on Paul Baran and Paul Sweezy’s 1966 classic, *Monopoly Capital: An Essay on the American Economic and Social Order* (New York: Monthly Review Press, 1966). Rather than a tendency for the rate of profit to fall,<sup>3</sup> Baran and Sweezy hypothesised a tendency for the relative share of the economic surplus<sup>4</sup> to rise. The main problem is one of finding ways to absorb this gigantic actual and potential economic surplus. “Underconsumption” – the shift in the distribution of income from labour to capital exacerbating the problem of effective demand – as an ex ante tendency draws the economy towards stagnation, for the process of accumulation of capital is predicated upon an increase in the rate of surplus value while at the same time having to rely on mass consumption to spur investment and economic growth. High levels of

inequality hold down the relative purchasing power of the working class, weakening consumption and adding to overcapacity, thus lowering expected profits on new investment, and thereby dampening the willingness to invest.

### Counteracting Tendencies

The problem of capitalism is that individual units of capital strive to expand their wealth to the maximum possible extent without considering the ultimate overall effect this would have on effective demand in the context of the economy’s expanding capacity. Truly, “The real barrier of capitalist production is capital itself”, as Marx once put it.<sup>5</sup> Under monopoly capitalism, this barrier is raised even higher. First, in the class struggle – the relationship between the two main classes, involving exploitation by capital and the workers’ resistance to it – capital has the upper hand, thus raising the rate of surplus value to attain a higher rate of profit, and thereby making possible a higher rate of accumulation. Second, with oligopolistic pricing, the uniform rate of profit of competitive capitalism gives way to a “hierarchy of profit rates” – highest in “tightly” oligopolistic product markets and lowest in the most competitive ones. This leads to a skewed distribution of the surplus value generated, one that favours the larger, more monopolistic firms; they, in turn, could “re-invest” a larger proportion of their profits, making possible a higher rate of accumulation. But on the demand-side, the large oligopolistic units of capital tend to regulate and slowdown “the expansion of productive capital in order to maintain their higher rates of profit”.

Underconsumption as an ex ante tendency and the problem of effective demand thus asserts itself even more under monopoly capitalism than under its competitive counterpart. But there are counteracting tendencies. Civilian government spending picks up some of the slack in effective demand; however, there are forces opposing such spending, especially where the projects or activities undertaken either compete with private enterprise or undermine class privileges. But there are other offsetting tendencies, such as militarism and imperialism, expansion of the sales effort, and financialisation,<sup>6</sup> which have

been the main external stimulants boosting effective demand and thus aggregate output. As already mentioned, financialisation has been functional for capitalism in the context of a tendency to stagnation; indeed, more recently, it has been the main “response of capital to the stagnation tendency in the real economy”. But the present crisis of financialisation, symptomatic in the financial crash, “inevitably means the resurfacing of the underlying stagnation endemic to the advanced capitalist economy” and there now seems to be “no other visible way out for monopoly-finance capital” (p 133).

### ‘The Truth Is in the Whole’

It must be mentioned that the book focuses almost exclusively on the financial crisis in the context of the us economy. No doubt this is the epicentre of the catastrophe. Nevertheless, in these times of financialisation of the capital accumulation process globally (albeit, an Americanisation of global finance), if one were to go by Hegel’s dictum that “The Truth is in the Whole”, then to understand what is going on in the us, one has to also take account of what is happening in the whole world, just as developments in the us make a difference elsewhere. In particular, the structure and distribution of world effective demand along with the huge imbalances reflected in the massive deficits and corresponding surpluses in the current accounts of the balance of payments of the major economies, and the structure of capital flows<sup>7</sup> thereby engendered, need to be brought into the picture. The neo-mercantilist direction of the Chinese, German (also, some other European economies), and Japanese economies come to mind, which needs to be taken together with the fact that despite the phenomenal rise in inequality in the us, the country’s savings rate has secularly declined, in part due to the wealth effect brought on by financialisation. These developments have, in turn, led to increasing us current account deficits, matched by huge capital inflows, and reflected in the accumulation of massive non-resident holdings of dollar-denominated financial assets. To what extent has all of this buttressed the speculative mania and the crash?

Again, confronted with Hegel’s dictum, and reminded of Rosa Luxemburg’s thesis

of capitalism's imperative to move into the non-capitalist regions of the world, we might also ask whether as time has gone by in this post-cold war era of a fully globalised capitalism, the system is now more prone to deep crises, given that it can now grow only by *internal* expansion.

### 'Monopoly-Finance Capital'

The main chapters, apart from the introduction, were "originally written as parts of a running commentary [in the *Monthly Review*] during the years 2006-08 as the present crisis took shape" (p 21). In fact, the four chapters following the introduction – "The Household Debt Bubble" (May 2006), "The Explosion of Debt and Speculation" (November 2006), "Monopoly-Finance Capital" (December 2006), and "The Financialisation of Capitalism" (April 2007) – were all written before the crisis began. But this does not diminish their value. The chapter on "The Household Debt Bubble" presents interesting data, for instance, debt service payments as a percentage of disposable income by income percentiles, which together suggest that "financial distress is ever more solidly based in lower-income, working-class families" (p 31). The chapter on "The Explosion of Debt and Speculation", after presenting data on the sky-rocketing of debt – household, non-financial sector, financial business, and government – suggests a decline in the stimulatory effect of the expansion of debt on the economy as a result of its changing composition. In particular, "financial sector debt now larger than any other single component and growing faster than all the rest (a shift from  $M-C-M'$  to  $M-M'$ ), may explain much of the decreased stimulation of the economy by debt expansion" (p 49).

Importantly, in the chapter on "Monopoly-Finance Capital", the authors argue that the new way monopoly capitalism has found of reproducing itself, namely, through the explosive growth of finance, suggests that it has moved into a "new hybrid phase", which they designate "monopoly-finance capital"<sup>8</sup> (p 64). Drawing on Sweezy, the chapter outlines how the "financial explosion has reacted back in important ways on the structure and functioning of the corporation-dominated "real" economy"<sup>9</sup> (p 66). And, in the chapter on "The Financialisation of Capitalism", Foster and

Magdoff profile its class and imperial implications (pp 84-88).

But, in order to absorb these and other insights in each of the six chapters, the reader will have to put up with a lot of repetition. And, there seems to be an analytical flaw. In chapter 6, in a section "From Financial Explosion to Financial Implosion" dealing with the instability and fragility of a system, while examining the massive increase in private debt, the authors state that "the problem is further compounded if government debt (local, state, and federal) is added in" (p 122). This is analytically untenable. Unlike private debt instruments, us Treasury securities have a zero default risk – they can be held indefinitely (for they are continuously "rolled over") at no financial risk to the government or to the private sector holder, for the government can never become bankrupt if it borrows in the same currency it has the power to declare as legal tender (fiat money). In fact, in the midst of the present crisis, Treasury securities are preferred holdings, for they can be readily sold for money or pledged as collateral for availing of loans.<sup>10</sup> But of course, Treasury securities face purchasing power risk – inflation can erode their purchasing power or deflation can result in an increasing real value of the debt for the government.

There is apprehension though about the value of the dollar, the currency in which these securities are denominated – a depreciation of the dollar relative to the asset holder's own currency – but this foreign exchange risk is faced by such holders for all forms of dollar denominated assets that they may hold. A significant fall, though, in value of the dollar would adversely affect the very growth strategies of the us' neo-mercantilist rivals (China, Germany and some other European countries, and Japan), as also those of us financial interests (which exercise significant power and influence in shaping the us' exchange rate policy), predicated as these grand designs are upon the maintenance of a "strong" dollar. Given this, and the fact that the portfolios of the foreign assets of the neo-mercantilist powers are largely dollar-denominated, presently, all the countries at the apex of the global pyramid of power and wealth want a "strong"

dollar, and will thus do all they can to ensure this. So it is highly unlikely the neo-mercantilist powers will shift their foreign portfolios of wealth away from the dollar leading to a collapse in its value. However, with the plunge in the net worth of firms geared to the circuits of money capital alone, and the consequent decline in their relative power and influence, in the event of the dollar losing say 30-40% of its value, given its "overvaluation" in the light of persistently high us current account deficits, all hell is bound to break loose with a further deepening of the financial and economic crisis globally. The historical parallel over here is the loss of international confidence in the pound sterling in 1931 in the midst of the Depression and the many bankruptcies and financial failures that resulted there from. Is the international role of the dollar then at stake?<sup>11</sup>

### Crying Out for Answers

Clearly, we are all crying out for answers and there is a lot to gain from working one's way through this book. However, with all its strengths, there is something, I feel, missing in this volume – the authors refrain from taking on other Marxist writers on the subject. Marxists usually differ a great deal in many matters of interpretation and evaluation, and there is a lot to learn from their debates. There are, for instance, those who endorse Marx's falling rate of profit theory, with whom the *Monthly Review* school differs. The former focus on systemic tendencies that, they contend, have lowered the rate of profit, and seek to link these with the role of monetary and financial phenomena disrupting the accumulation process. The disinclination to debate with other schools of Marxist thought on the financial crisis is our loss. Picture the young Paul Sweezy, penning his *The Theory of Capitalist Development* in the 1930s, boldly taking on a whole bunch of Marxist thinkers on crisis theory, from Henryk Grossman to Mikhail Tugan-Baranovsky, and Marx too, and the positive "externalities" flowing from this initiative. Be that as it may, there is a whole new generation today wanting to know what caused the present financial catastrophe and what might be its likely ramifications. After all, not long ago, the

cold war ended with the restoration and triumph of capitalism on a global scale, and then, less than two decades later, capitalism is bankrupt. This book, with its cogency that is the hallmark of the *Monthly Review*, needs to be widely read.

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## NOTES

- 1 Keynes considered effective demand – demand, at a profitable price, for the volume of goods and services that could be produced with existing capacity – to be capitalism's most fundamental macroeconomic problem.
- 2 We follow what appears as the typical pattern of speculative bubbles from the 1980s onwards, as outlined by Paul Sweezy and Harry Magdoff, "The Stock Market Crash and Its Aftermath", in their book, *The Irreversible Crisis* (New York: Monthly Review Press), 1988, pp 43-55.
- 3 In Marxian terms, a rise in the "organic composition of capital" (the ratio of the value of used-up means of production and the value produced by "necessary labour") increases labour productivity, which raises the rate of surplus value – the ratio of the value produced by "surplus labour" ("surplus value") and the value produced by "necessary labour". So an increasing organic composition of capital proceeds *pari passu* with a rising rate of surplus value, making the direction in

which the rate of profit (the surplus value divided by the sum of the value of the used-up means of production and the value produced by "necessary labour") moves indeterminate. See Paul Sweezy's 1942 classic, *The Theory of Capitalist Development* (New York: Monthly Review Press, 1970), p 102.

- 4 The economic surplus is difference between total output and the "socially necessary" costs of producing it.
- 5 In this paragraph, we draw on Paul Sweezy's "Monopoly Capitalism" in John Eatwell, Murray Milgate and Peter Newman (eds.), *Marxian Economics* (London: Macmillan), 1990: 302.
- 6 Here, effective demand is stimulated via the "wealth effect" – a tendency for consumption to grow, even in the absence of the growth of incomes, due to rising asset prices.
- 7 The increase in net liability of a country to the rest of the world, represented by the current account deficit, if persistent and high, as in the case of the US, leads to a huge cumulative build-up of net claims by non-residents on the domestic economy. In contrast, in the case of a country with a current account surplus, there is a net outflow of funds, and, if that surplus is persistent and high, as in the case of countries following neo-mercantilist growth strategies, it will result in a huge cumulative build-up of net claims by residents on the rest of the world's economies. But, of course, there are also autonomous capital flows – strategic rivalry between nations is not merely manifested in trade; it also takes the form of controlling resources beyond national boundaries through foreign direct investment and militarism. And, given the role of the dollar as international money, the US has an advantage over its

neo-mercantilist rivals, China, Germany and Japan, in this respect – it can finance much of its foreign investment and militarism by creating monetary liabilities abroad.

- 8 According to Paul Sweezy, from the latter half of the 1970s a "relatively independent – relative, that is, to what went before – financial superstructure sitting on top of the world economy and most of its national units" began to take shape, emerging around the mid-1990s. See his perspective piece, "The Triumph of Financial Capital" (*Monthly Review*, Vol 46, No 2, June 1994, pp 1-11).
- 9 There is also the need to take account of the impact of increasing "openness" (in the trade and financial sense) on product market structures, for instance, the impact of foreign direct investment on transforming a "tight" oligopolistic market into a "loose" one, or the impact of price competition from imports on profit rates in oligopolistic industries facing global excess capacity. All this may call for a relook at the hypothesis of the relative share of the economic surplus to rise, using more recent data.
- 10 Prabhat Patnaik also finds it untenable to lump together the private and the public debt "to show the fragility of the system". See his "The Economic Crisis and Contemporary Capitalism", EPW, Vol 44, No 13, 2009, p 49.
- 11 The reference here is to the central role of the dollar in the gigantic web of global private capital flows. For a different but interesting approach to this question, see Ramaa Vasudevan, "The Global Meltdown: Financialisation, Dollar Hegemony and the Subprime Market Collapse", EPW, Vol 44, No 13, 2009, pp 193-99.

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