Lesson : Analyzing U.S. Crisis from Marxian Lens

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Learning outcomes:

After you have read this chapter, you should be able to: -

- List various macroeconomic theories and time periods in which they flourished.
- Distinguish between primitive and extended accumulation.
- State reasons for profitability crisis of 1970s.
- Define fictitious capital.
- Explain how bubbles are created and burst.

I. Introduction

The reasons for current US economic crisis of 2008 are widely debated and macroeconomists have tried to model it in Keynesian or Minsky framework. An alternative explanation is provided by Marxian theory of crisis. Though there is vast literature available on the topic but in this chapter we would concentrate only on Vamsi Vakulabharanam's paper.

The discussions regarding US crisis revolves around having sector boom, bubble burst, financial sector collapse and it's spread in the entire world. The current paper under discussion finds the roots deeper than this. The seeds of this crisis were sown long back in late 1960's as envisaged by Vamsi and not in 2000's as explained by others.

This chapter is divided into sections. First section describes the features and ideologies of era prior to crisis. In the second section, we discuss profitability crisis of 1960's. Third section describes accumulation in neoliberal regime that avoided crisis of 1970's but led to the formation of current US crisis.

II. Mainstream macroeconomic theories

To understand every present situation, its context and history that built former, must be studied. Historical events in the past could be relevant in explanation of present scenario. Not only events but also then prevailing ideology assumes importance. In this section we will study the period preceding current crisis.

II.1 1929-45

The world witnessed **Great depression** during this period. During this period and prior to it, classical ideas of free market economy, no government intervention, Say's Law (i.e. no possibility of overproduction) were followed. Classical economists never envisaged the possibility of crisis. So this made provision for acceptance of JM Keynes Theory, since his theory could fit and explain the then crisis. Also, JM Keynes' solution provided in 1936 helped recover Great Depression. JM Keynes called for the need of big government, who by their massive government expenditures could help fulfill demand gap.

II.2 1945 – late 1960's

This period is referred to as '**Golden age of Capitalism**' because capitalism experienced rises in profits and simultaneously worker's real wages were keeping pace with increase in labor productivity. Two remarkable features of this period are:

i. Labor unions had become too strong so that labor had bargaining power to demand hike in real wages and cut in wages could always be refrained by exercise of power by labor unions. Recall wage Squeeze theory of crisis in this respect.
ii. Politicians and macro economists relied on big governments that were inefficient and faculty policy structure of national Keynesianism eventually led to financial crisis.

II.3 1970's

The Keynesian school of thought was considered no longer survive in 1970's and a new regime called '**neoliberalism'** emerged. It changed capitalism's way of functioning in the following ways:

i. State gave up the role of production and only concentrated on the role of a facilitator in the capitalist society. State would have to ensure that capitalists profits don't dip. Finance capital was freed from the shackles of government and state threw away its properties at throwaway prices. Regulation of finance capital was relaxed.
ii. Finance capital dominated all other forms of capital and gained importance in making of structure of capitalist society.
iii. Labor was disciplined enough to bargain better wages and benefits.
iv. Fixed exchange rate was simultaneously abandoned in 1971.

II.4 1980's

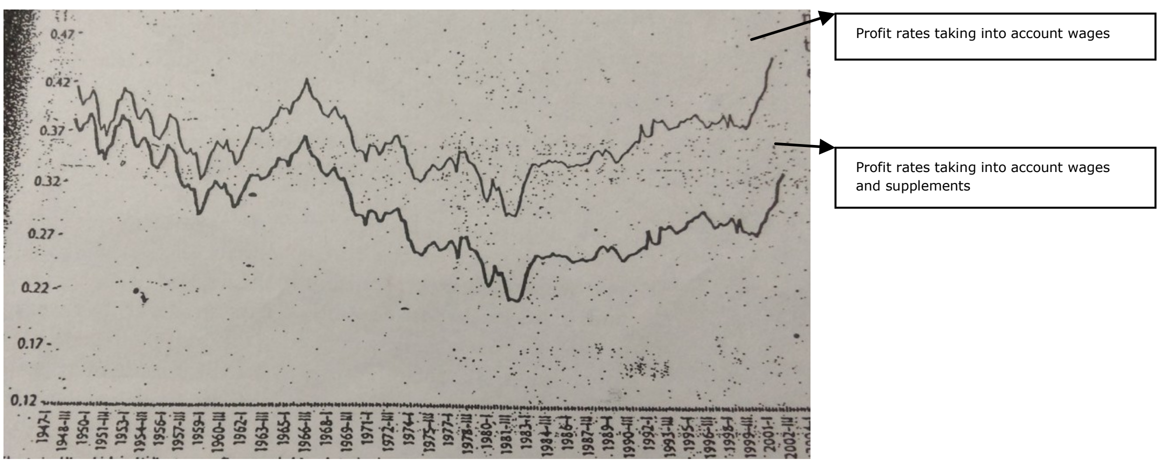
By 1980's it was widely held belief that market mechanisms are self correcting and self equilibrating and there was a shift from neo classical Keynesian Synthesis to **new classical economics**. This process was globalised by world level organizations- IMF and World Bank that helped its spread in developing nations too.

III. Profitability Crisis

After experiencing golden age of capitalism, capitalists began to witness fall in the rate of profit in mid 1960's; as can be seen in figure 1. The profitability crisis emerged due to the following reasons:

i. Profit squeeze due to strengthening of labor.
ii. Productivity growth slowed down.
iii. Secular falling rate of profit.
iv. Foreign competition that capitalists in US economies were subject to originated from other advanced nations like Germany and Japan were sources of competition.

Figure1 :US profit rates (1947-2004)



Source: Vamsi vakulabharanam, 'the recent crisis in global capitalism: towards a Marxian understanding, March 2009

In response to profitability crisis, the creation of new regime of accumulation (neo liberalism) was introduced. It shifted assets from state and other vulnerable groups to the capitalists. Along with it, credit was expanded substantially so that consumption growth could never fall to a level low that under consumption crisis became order of the day. In actual to avoid 1970's crisis, the proposed solution created temporary booms and sustainability of growth was not assumed.

IV. Accumulation

Marxian analysis could fit well to this crisis as the current crisis is not just a financial crisis because process of production, appropriation and distribution of surplus value was interrupted in the neoliberal model. Before we proceed lets recall the concept of capital accumulation as given by Marx

IV.1 Marxian understanding of accumulation

Marx explains two sorts of capital accumulation.

a) **Primitive Accumulation**- Peasants and artisans became the ones without means of production in capitalist society and offered their labor power like merchants, landlords became capitalist class- the owners of means of production.
b) **Extended Reproduction**- Money capital is used in buying labor machinery and other means of production. These then are employed in the production of commodities.

Recalling from the last chapters that labor is divided into necessary labor and surplus labor and it is the labor that helps in creation of surplus for the capitalist. Apart from the creation of surplus, realization of it in the market is equally important.

After the sale of commodities, the money that the capitalists receive is greater than the money he started with and the difference between the two is surplus, ΔM. s there could be crisis due to interruption in either of two viz. creation of surplus or realization of surplus.

IV.2 Accumulation in 1970's: Fixes to profitability crisis of 1960's

Publically owned properties or common properties showed in steady decline in neoliberal regime and private players dispossessed peasants and other vulnerable groups. Also, capitalists started looking for profitable avenues beyond the boundaries of a nation. Financial capital became highly mobile and capital saw a movement from advanced economies to less developed economies. This was one of the fixes of profitability crisis of the late 1960's.

The other fix to the crisis was made through extended reproduction. Since crisis were thought to be as profitability crisis so real wages fell between 1973 and 1996 in the US. Fall in real wages would increase the rate of exploitation s' and so would the rate of profit. Also capital migrated overseas to populated less developed nations so that profit levels could be sustained with the use of cheaper labor available in poor nations.

Labor productivity was given a boost. Rise in labor productivity along with stagnant wages meant that gap between productivity and wages widened starting from 1973 to 2005.

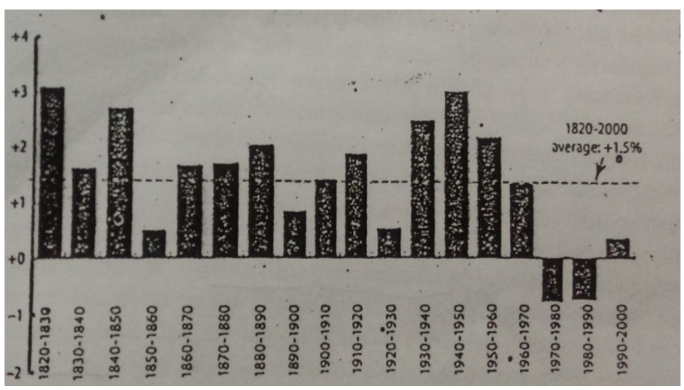
IV.3 Problem with the fixes

The fixes that were designed to avoid profitability crisis actually led to the crisis of realization. The fixes in this sense were temporary. They did nothing more than postponing crisis and simultaneously growing the adversity of crisis. Let us discuss each fix and its implications in details.

a) **Fall in real wages**

US workers witnessed the fall in real wages from 1973 and it continued until late 1990's. As one can see in the following figure, US workers experienced rise in real wages for 150years prior to fall in 1973. The working class expected rises in real wages and could not adjust its consumption pattern on realization of actual situation. They resorted to work more, women entering labor force and even borrowed to fulfill their demand.

Figure 2: Decadal growth of real weekly earnings of the US working class (1820-2000)



Source: Vamsi vakulabharanam, 'the recent crisis in global capitalism: towards a Marxian understanding,March 2009

The flip side of borrowing by working class was that capitalists could now earn interest by lending their money out of surplus. The result of such a kind of activity was that working class had twin burden in the form of lower wages and interest due on their loans.

b) Liberalization

IMF and World Bank pursued that benefitted financial capital. The real interest rate and inflation; and real interest rate is high when inflation rate is kept low. Deflationary policy would mean reduction in effective demand and hence realization problem was aggravated.

c) Deflationary policies

Deflationary fiscal policies were pursued that benefitted financial capital. The real interest rate is the difference between nominal interest rate and inflation; and real interest rate is high when inflation rate is kept low. Deflationary policy would mean reduction in effective demand. Hence, realization problem was aggravated.

To fix this, huge investments were made into China from developed countries and US played role of 'market of last resort'. This role of US meant excess burden upon working class of US and this in part explains huge current amount deficits of US. This meant people in rest of the world held dollars and capital flowed back to US (capital account surplus).

The working class of US had to resort to borrowing due the burden created due to role played by US. The financing of such loans was easy as liquidity was created by the inflow of capital especially from China, Japan, and other Asian economies.

IV.4 Fictitious capital

The decade of 1990's witnessed explosion of fictitious capital that further added to the existing problems of fixes attempted in neoliberal regime. Before we move on to argue how fictitious capital assisted creation of bubbles and its burst, let's understand fictitious capital.

Marx explained fictitious capital in his book, Capital, Volume 3. Fictitious capital is different from real capital; since real capital is directly engaged in production process while fictitious capital is not. Fictitious capital provides future claim over future income/surpluses to its holder. For instance, a building (real capital) has value in the market and based on it or keeping building as collateral, if a paper title is generated then this paper title is referred to as fictitious capital. Collateral would be fixed capital or durable commodity and instead of this collateral, paper title are circulated and the value of latter depends on the value of the former. A point will be reached when these paper titles would assume an independence from the collateral (recall fetishism).

How bubbles are generated and how fictitious capital could shape up crisis? When value of collateral falls, accumulation based on fictitious capital is called off. What determines the value of collateral? Value of collateral depends upon unsold commodities or unrealized incomes.

House price bubble being pricked in 2007

If production of surplus value does not keep pace with future claims of fictitious capital then crisis is an inevitable outcome. (For analogy, you could assume that a company has to earn enough profits so that debenture holders i.e. the holders of fictitious capital are paid and still surplus is left over. If it does not hold then the company fails). On the other hand, if the value of collateral moves in favourable direction, this would help in the creation of asset bubbles.

Fictitious capital was actually designed to provide liquidity so that the process of accumulation can go smoothly and uninterrupted. The role of financial intermediaries becomes important here who borrow short term and lend long term. The producers or even consumers could finance their current accumulation or consumption (partly solving realization problems) respectively. It could become a regular practice wherein producers or consumers refinance their debts on regular basis or by promising claims over their future surplus/ income.

Marx argued that a point in time could be reached where fictitious capital- that was to serve real economy- would have all ties cut with real economy and would establish enclave of its own.

IV.5 Role of fictitious capital in current crisis

Financial engineering in the recent time gifted us with various derivatives, collateralized debt obligations, mortgage backed securities, credit default swaps etc. to ease the operations provide hedge against losses and hence, to aid smooth working of capitalism. The world witnessed a sudden explosion in value of these instruments and a growing market for these.

These paper titles/ securities circulated not only in US and other advanced nations but in all countries across the globe and that is how non repayment of loans in US engulfed the entire world and brought global meltdown. Investment banks bought capital assets all over the world, leveraged themselves heavily and became carrier of crisis to all other nations.

Size of Derivatives market

The size of global OTC derivatives market in 1990s was $16 trillion. In the decade preceding global crisis derivatives witnessed an upsurge and it steadily grew to $595.341* trillion in Dec.2007.

To understand that it grew much larger in relation to real economy, global GDP was just $60 trillion in 2007-08. The size of derivatives market was approximately ten times the size of global GDP.

These investment banks engaged themselves in risk-taking activities with the theoretical knowledge that risk levels are well computed and it is beneficial to undertake such risks. But they forgot about systematic risk. Systematic risk is conferred upon all and cannot be avoided. It is the risk that is inherent in the entire market. Each individual does not take into consideration this systematic risk and forgot about the market outcome that will follow the collective action of buying fictitious capital (by each one in economy). When claims on future surplus value outpaced the actual surplus value creation, the bubble of fictitious capital began to burst. This happened in US with housing sector and as the financial firms started deleveraging crisis spread across the globe.

Realization crisis cannot be postponed forever. It could only be delayed through endless borrowing and deployment of fictitious capital. The temporary booms that fed on bubbles would essentially end.

House price bubble and bust

Source: American Enterprise Institute website

House price bubble meant that price of houses in US kept on rising and bubble was formed due to lack of commonsense. The lack of commonsense refers to the belief of people (investors) that house prices will keep on rising as they had been. It seems like good deal to borrow (with no cash down payment) for an asset whose price is soaring.

Credit funds were available and simultaneously US government policy of easier terms for housing loan meant that loans were 'subprime'. Since loan requirements were easy and house itself was kept as mortgage, lenders received 'jingle mail' when borrowers experienced 'upside down' i.e. borrowers dropped keys in the mail box of the house.

Banks, in 2007, as a response to defaults on their loans, reduced new lending called 'credit crunch'. This furthers the process of lowering price of houses by lowering demand and leaving excess supply of houses for sale. Hence, house price bubble busted.

V. Crisis in capitalism

Keynes' solution of government intervention for creation of effective demand in market can correct realization problem but will lead to other sort of crisis i.e. crisis of creation of surplus value. As it can be observed, that capitalism has experienced such oscillations in last couple of decades. Twentieth century capitalist experience state- capitalism and market oriented capitalism circuit.

The period that led unto Great Depression in 1929, had serious realization problem to which Keynesian solution of state assistance could rectify and result was Golden Age of capitalism. But this was not sustainable as state led capitalism created profitability crisis and as a solution switch from state capital to market oriented capitalism appeared. In market-oriented capitalism, there is excess accumulation of capital leading to bubbles followed by its burst, like the one witnessed in current period.

This seems to create perpetual oscillation between the state and the markets. But none of these guarantee stability. Could there be an optional mix of the two? Marx disagrees to it. What could be done then? First is regulation. But the regulator is always lagging behind the innovator. Second is 'socialization of investment' for which generating a consensus is nearly impossible. Then it seems like that capitalism can never fully work out its crisis and these are inherent in the system and a regular feature of capitalism.

Summary

- US witnessed profitability crisis in 1970s due to wage squeeze, productivity slowdown and competition from Asian economies.
- Neoliberalism was adopted in response to profitability crisis of 1970s and as result of this finance capital was freed from the clutches of regulation in the hands of private players. The mobility of finance capital and its movement meant that entire world was connected by flow of finance capital.
- Accumulation regime of neoliberalism devised fixes. But these fixes aggravated problem of crisis. These fixes provided boost to borrowing in capitalism and there were channels created that could finance this borrowing. This temporarily fixed the problem of profitability.
- Along with growth of borrowing at unprecedented scale, financial innovation of new instruments sustained asset bubble creation. Eventually housing sector bubble busted.
- Capitalism has witnessed perpetual oscillations between state led capitalism and market oriented capitalism. But there seems no end to crises in capitalism.

Exercises

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Question Number	Type of question

1	Multiple Choice question

Question

i) The period between 1945 and late 1960s is termed golden age of capitalism because:
   a) Profit were increasing
   b) Productivity were increasing
   c) Wages were increasing
   d) All of above.

ii) Which of the following if fails will lead to crisis?
   a) Production of surplus value
   b) Realisation of surplus value
   c) (a) & (b)
   d) None of these.

iii) Fall in wages post 1970s could not circumvent crisis because it created :
   a) Demand gap
   b) Asset bubble
   c) Growth of fictitious capital
   d) Current account deficits.

iv) Match the following:

A) Neoliberalism		i) Golden age of capitalism
B) 1945-60		ii) state-led capitalism
C) Late 1960s to 1970s		iii) 1929-33
D) Great depression		iv) state as facilitator

	(A)	(B)	(C)	(D)
a)	i)	ii)	iii)	iv)
b)	iv)	I)	ii)	iii)
c)	ii)	iii)	i)	iv)
d)	iii)	iv)	ii)	i)

Correct Answer / Option(s)	i) → d) ii) → c) iii) → a) iv) → b)

Justification/ Feedback for the correct answer

i) Increase in productivity was shared between laborers and capitalists.
ii) Either can mean crisis in the economy.
iii) Fall in wages means less of purchasing power in hands of people that is not sufficient to buy back the entire production.

Question Number	Type of question
2	True or False

Question

a) If increase in wages is controlled then crisis would not emerge.
b) National Keynesian can avoid only realization crisis.
c) According to Vamsi " crisis could never end in capitalism".
d) Reckless borrowing creates booms based on bubble.

Correct Answer / Option(s)	a) False b) True c) True d) True

Justification/ Feedback for the correct answer

a) Profitability crisis won't emerge but realization crisis could.
b) Government could create effective demand and help solve realization crisis. But if crisis is in surplus creation then big governments can't help rather deteriorate situation.
c) He concludes that one type of crisis runs into formation of other.
d) Easy borrowing terms for housing loans created demand for houses and house price bubble was formed.

Question Number	Type of question
3-6	Long answer question

Q3. Explain how fixes to crisis of surplus creation created basis for current crisis.

Q4. When Keynesian nationalism is successful in avoiding crisis under capitalism? When, not?

Q5. Is there an end to crises under capitalism?

Q6. "Capitalism has been experiencing perpetual oscillations between state-led capitalism and market oriented capitalism". Comment.

Glossary

- **Neo-liberalism:** Neo-liberalism is the ideology that free market economy is efficient and calls for cut in government expenditure, liberalization and privatization.

- **Fictitious Capital:** Fictitious capital is that proportion of capital, which cannot be simultaneously converted into existing use-values.

- **Leveraging:** Any action of the firm can be tagged leveraging if in order to multiply profits firm finance assets through debt and/or use financial instruments like options.

- **Asset Bubble:** Asset bubble is formed when price to asset plunge in short period of time and price rise is bid up by investors beyond real value.

References

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