

Crises in Capitalism



Lesson: Crises in Capitalism

Lesson Developer: Vaishali Kapoor and Rakhi Arora Sharma

College/ Department: DDU and Rajdhani College, Delhi University

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Learning outcomes:

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

- a) Define Economic Crisis
- b) Explain phenomenon of 'overproduction'
- c) Distinguish between possibility theories and necessity theories
- d) State role of State in possibility theories of crisis
- e) Describe under-consumption crisis.
- f) Narrate disproportionality crisis.

I. Introduction

Crisis and its aftermath have been in news headlines, debates, books journals and research papers. It is also the cause of worry for every government and business. Macroeconomists and researchers around the globe are trying to reason out the causes for current crisis. Various macro-economic theories: Keynesian, classical, Marxian, Austrian, Minsky etc. are used as theoretical models for explanation of recent crisis.

In this chapter we will discuss crises and their nature in capitalism. This chapter is divided into three sections. First section provides crisis origination in capitalism. In the second section, simple and extended reproduction scheme are explained and their equilibriums are established. Third section discusses various types of crises.

II. Capitalism and Crisis

Even in the societies prior to capitalism, crisis was prevalent but with different reasons. The reasons for crisis were natural disaster, war or some catastrophic occurrence that interrupts the production of commodities and acute shortage becomes one of the reasons for emergence of economic crisis. But in capitalism the crisis follows the unsalable commodity surplus. In this section, we will explore how circulation of M-C-M' is interrupted and engulf the capitalist's society into crisis.

II.1. Overproduction Vs Say's Law-

Say's explains, "Supply creates its own demand". Say's Law alleges that a sale is followed by a purchase of equal amounts. Ricardo (another classical economist) further pursues this and remarks that circulation of C-M-C is never interrupted and the producer produces either to consume or sell.

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The production then is either consumed by producer or he sells it for other goods and money is only medium of exchange and interruption is C-M-C is also then imaginary.

Marx disagrees to it and questions that why would buy since other person has to sell. Also, he considers role of money beyond what Ricardo described i.e. to split exchange into two separate transactions: purchase and sale. What if first producer (A) sells his goods and does not buy from other (B)? Then, in that case since B is unable to sell his goods, he won't buy from C and C in turn would fail to buy it from D and the chain goes on. The end result of this is overproduction by all in this chain starting from B.

II.2. Circulation M-C-M'

If the circulation under simple commodity production i.e. C-M-C is considered; then overproduction can be considered an impossibility since production is for consumption. But in capitalist order, circulation takes the form of M-C-M'. Creation of the surplus i.e. $\Delta M = M' - M$ is the sole objective of a capitalist. Capitalists undertake production for profit and this makes capitalist society vulnerable to crisis: crisis of overproduction.

Capitalist is interested in expanding surplus, ΔM as large as possible. Rather it is not absolute ΔM but ΔM relative to the magnitude of the original capital i.e. $\Delta M/M$. This $\Delta M/M$ is nothing but another way of representing the rate of profit. Keeping in mind the M-c-M' circuit and the rate of profit as aim of capitalist, let's explore the possibility of crisis in capitalism.

Any break may it be in simple commodity production circuit C-M-C or in M-C-M' circuit, will result in crisis. Any withholding of buying power from market, will initiate a contraction in the circulation process and will result in 'overproduction'. Overproduction in first year would mean that producer would curtail production in forthcoming years. Equivalently, any disruption to ΔM would translate into doubts about profitability and hence, producer would be hesitant to throw his money M into circulation.

There are two sorts of possibilities. **Firstly**, ΔM disappears or becomes negative. This would kill every incentive of a capitalist to reinvest money. This phenomenon could be witnessed but can't explain the onset of crisis. Rather this would be the outcome of depression that the entire economy suffers losses (negative ΔM). **Secondly**, there could be fall in ΔM or fall in the rate of profit. Rate of profit can be assumed to fall but yet remains positive. Since, it is the rate of profit that keeps capitalist interests and fall in it could create grounds for capitalist to curtail their operations and the curtailment to be sufficient for the onset of crisis? The answer is YES.

When rate of profit falls below usual range, capitalist will not invest in that industry and will look for other industry where he could reap usual rate of profit. If, however, all industries are experiencing fall in the rate of profit then he can do no better than postponement of investment till the favorable conditions are on the cards. In the meantime, the postponement of reinvestment by all capitalists would have already disturbed the circulation process and the crisis precipitate.

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What could have saved the onset of capitalism crisis? Following are the explanations to it (though at times not possible):

a) Increase in consumption by capitalist

If capitalist increases the personal consumption during the phase of low rate of profit. Then only demand's composition will alter keeping circulation process intact. But since it was argued that capital accumulation is what capitalist always desire for and this urge to accumulate capital never withers away. The driving force behind capital accumulation is the rate of profit and also the capitalist is interested not in the use value but in exchange value i.e. expansion of surplus value and capitalist would not produce output for its immediate consumption (contrast it with C-M-C).

b) Fall in the interest rate

Before we discuss this point; what is usual rate of profit? How low we consider, when we refer to lower rate of profit? It is lower than which level? Answer to it is the rate of interest. Modern theorists explain that there are two types of capitalists: those who undertake production, entrepreneurs and those who supply funds at pre specified interest rate, money capitalist. If rate of profit falls below the interest rate, then entrepreneurs would not borrow from money capitalist and this breaks the circulation process and seeds for crisis are sown.

It seems plausible that fall in interest rate could trouble shoot this problem. But in actuality, money capitalists' desire to loan funds dies away with fall in the interest rate.

To conclude, capitalists would have to postpone their reinvestment decision till the demand in the market has picked up.

III. Simple and Expanded reproduction

In the simple reproduction scheme, we assume that there are two departments viz. Department I and Department II. Department I produces means of production or capital goods and Department II produces consumption goods or wage goods.

Total value in Department I, $w_1 = C_1 + V_1 + S_1$

Total value in Department II, $w_2 = C_2 + V_2 + S_2$

Where,

'C' represents constant capital

'V' represents variable capital

'S' represents surplus

'1' used as subscript for Department I

'2' used as subscript for Department II

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Total surplus- sum of S_1+S_2 - is consumed by capitalist i.e. expenditure is made on consumption goods. Wages given to workers is also consumed by the workers. So, capitalists and the workers demand consumption goods. For equilibrium, total demand for consumption goods should equal total value produced in Department II. Algebraically,

$$V_1+V_2+S_1+S_2=C_2+V_2+S_2$$

$$\mathbf{V_1+S_1=C_2}.....(i)$$

' C_2 ' is the demand for constant capital by Department II from Department I. ' V_1+S_1 ' is the total demand for consumption goods by Department I from Department II. So, equilibrium condition requires that net demand (demand from other than own department) equals net supply (production supplied to all departments but its own). If this condition is satisfied, the scale of production remains unchanged from year to year.

Simple reproduction scheme ignores the fact that capitalists desire to accumulate capital, which is taken into consideration in expanded reproduction scheme. For this reason, surplus that accrued to capitalist is divided into four parts. **First**, consumption by the capitalists should be at least at the last year level of consumption, S_c . **Second**, increment in their consumption, $S_{\Delta c}$. **Third**, capital accumulation or addition made to constant capital, S_{ac} . **Lastly**, surplus is spent on wages (variable capital) on newly recruited workers to work on with additional constant capital, S_{av} . So, the surplus equals sum of these FOUR components.

$$S=S_c+ S_{\Delta c}+ S_{ac}+ S_{av}$$

With these assumptions about surplus value, we now work out equilibrium conditions in expanded reproduction scheme. The reproduction scheme for two departments works as follows:

$$C_1+V_1+S_{C1}+ S_{\Delta c1}+ S_{ac1}+ S_{av1}=W_1$$

$$C_2+V_2+S_{C2}+ S_{\Delta c2}+ S_{ac2}+ S_{av2}=W_2$$

For equilibrium, demand for capital goods must equal total output of constant capital and demand for consumption goods must equal total output of consumption goods. Algebraically, it is expressed as follows:

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$$C_1 + S_{ac1} + C_2 + S_{av2} = C_1 + V_1 + S_{C1} + S_{\Delta c1} + S_{ac1} + S_{av1}$$

And

$$V_1 + S_{C1} + S_{\Delta c1} + S_{av1} + V_2 + S_{C2} + S_{\Delta c2} + S_{av2} = C_2 + V_2 + S_{C2} + S_{\Delta c2} + S_{ac2} + S_{av2}$$

After simplification both reduce to the following equation:

$$C_2 + S_{ac2} = V_1 + S_{C1} + S_{\Delta c1} + S_{av1} \dots \dots \dots (ii)$$

The results derived thereof will be used while explaining the under consumption and disproportionality crisis (will be discussed in the coming sections).

IV. Types of crisis

Crisis would be divided on the following two bases:

a) All commodities sell at the equilibrium value or not.

Crisis can be associated with tendency for falling rate of profit and all commodities are assumed to sell at their equilibrium values. On the other hand, it could be that capitalists are unable to sell the commodities at their equilibrium value and it is termed as '**realization crisis**'.

b) Role of State

The tendency of falling rate of profit and various counteracting tendencies are assumed to be at equal footing, then balance of forces will determine system's final direction and crisis is a possibility and leaves scope for state action to regulate the outcome. This is the **possibility theory** of crisis. If tendency of falling rate of profit is assumed dominant and other tendencies operate within the limits set by former then crisis is inevitable and state can no longer effectively control the outcome. This is the **Necessity theory** of Crisis.

IV.1 Under-consumption Crisis

Under-consumption crisis is clubbed under the **possibility theory** of crisis and is also known as Stagnation Theory of Crisis. In capitalist form of production, wages are paid to the workers and profits accrue to profits and the sum of these two constitute value of net product with latter being growing in comparison to former. Hence, wages (that are spent on goods) are always not sufficient to buy back the entire production and '**demand gap**' is generated. Greater the share of profits to wages, greater is the demand gap.

In capitalists savings (viewed as 'leakage') is not spent on goods then a part of the production would not be sold or at least at their normal value. So viewed in this sense, it is a type of realization crisis. This would not cease till profits contract to a level so low that capitalists are forced to consume their entire income. Not that demand gap can only be filled by consumption but also by investment demand. Investment demand would also lead to higher level of production and employment. The interplay between stagnating tendency- savings by capitalists and countervailing

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tendency of expansion- investment by capitalists; will determine the final outcome for the system.

Capitalists save in order to grow and for honour, respect in the society. But the decision to invest or not rests upon two factors:

Foundation for large scale commerce and trade- when there is economic, political and international stability, then under such normal conditions capitalist would invest and would have optimistic view about profitability in future.

Fuel for large scale investment- when new products, new markets and new technologies coincide, then this become opportunity for capitalists.

Foundation and fuel together forms basis for expansionary forces. If fuel runs out and rivalries among capitalists undermine foundation, then stagnation becomes order of the day.

In modern times, monopoly capitalism is relevant form of capitalism under which a few firms dominate industry and restrict output and charge higher prices. In this way, capitalists' profits are yet very large compared to wages to the workers. This makes even greater demand gap and makes crisis then inevitable.

Since, there is demand gap that brings crisis; state can be very helpful by either spending directly or by providing stimulus to private spending. Though feasibility of such an option is monopoly capitalism is susceptible. In response to state's action, monopolists would raise prices than expanding output. Hence, state can play important role in restricting monopolies through price controls and regulation. Increased social welfare and higher wages would not only benefit workers but also to the capitalists or to capitalist society as a whole.

IV.2 Wage Squeeze

With the rise in real wages and other things being equal, rate of profit tends to fall. But rise in real wages have to be sufficient enough to offset the rise in productivity of labor, for rate of profit to be on decline. Wage theorists believe real wage rise to be only reason for fall in the rate of profit, which otherwise would have increased. Since, here too we assume tendency for fall in the rate of profit: rise in real wages and countervailing tendency: rise in productivity to operate at equal footing; hence wage squeeze is a part of **possibility theory** of crisis.

To offset the demand gap created by monopoly capitalists, state can undertake policies and sustain the boom. But if boom lasts for long, it reduces reserve army of labor and hence, exerts upward pressure on real wages, which then lowers the rate of profit, and crisis becomes inevitable. State intervention, to avoid under consumption crisis, turns under consumption wage crisis into wage squeeze. State can help recovery of capitalism if state can maintain both rising of profit and real wages.

IV.3 Falling rate of Profit sustained crisis-

Marx's falling rate of profit theory is **necessity theory**, wherein fall in the rate of profit is assumed to be dominant theory and others as countervailing forces that are

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subordinate to the former. In this theory, all commodities including labor are assumed to be selling at equilibrium value and therefore, its not a type of realization crisis.

As we have discussed in the last chapter, rate of profit, 'p' is the function of organic composition of capital 'q' and the rate of surplus value, 's' :

$$P=s'(1-q)$$

Capitalists accumulate constant capital to extend their control and displace labor by machinery. This causes 'c' and organic composition of capital to plunge. Assuming rate of surplus value constant, increase in q will reduce the rate of profit. Although increased use of machinery would increase labor productivity but this counteracting cause operates within the limits defined by dominant tendency.

The impact of downward trend in the rate of profit is that capitalists would curtail investment demand because for a capitalist the driving force behind capital accumulation is the rate of profit. Also for the time being, real wages rise, and due to the slowdown of investment, productivity falls; so constant wages would mean increase in real wages. Viewed this way, **'under consumption' and 'wage squeeze' are the outcomes of profitability crisis.**

Since profitability crisis emerge due to capitalism system's built in character of capital accumulation and cannot be done away with either by raising wages and/or curtailing monopolies; so one can conclude that state can't manage profitability crisis. If capitalist system is to be maintained and crisis to be avoided, then it would require attack on workers and political parties will be unwilling to do so (since its not populist action). Marx viewed possibility of socialist system overthrowing the capitalist system itself as one of the solution to crisis in capitalism. Capitalist system will come to an end when profits- the enlivening force- keeps on going down and never rise.

IV.4 Disproportionality crisis

Tugan postulate that disproportionality is the only cause of crisis. If every producer produced goods in correct proportions then market would never be flooded with unsalable commodities and 'no overproduction' or 'no under consumption' can be seen. If the relative proportions of commodities are correct then the commodities would sell at their values and in case of any disturbance, capitalists would face realization problem and disproportionality crisis is also a type of realization crisis.

In the capitalist order, each capitalist produces for market; the size of which he estimates before undertaking production and with imperfect knowledge either he ends up with 'too little' or 'too much' for the market. Trial and errors year after year would eliminate errors and correct proportions would then be attained. But the economic environment under which capitalists operate is under constant change. If capitalists over estimated the demand in the market, then the result will be overproduction. In the forthcoming years, he would lower production and so will the demand for labor and employment.

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Assuming that the expansion in commodity production in other branches of production will follow the curtailment in one industry is unreasonable. Had it been the case, deficit in production in one industry could have been made up by others. Since there is no valid ground for acceptance of such an assumption (that why others would expand production) means that circulation process is interrupted. If this interruption is large one, then it could threaten the working of entire capitalist system and calls for crisis thereof. The crisis had emerged due to disproportionality between various branches of production. This disproportionality has its own roots in plan-less, anarchic character of capitalist production.

This crisis had roots in disproportionality between various branches of production. Marx believes that disproportionality can be due to faulty employment of labor among spheres of production. Market value, in response, rises or falls and results into the withdrawal of capital from one sphere of production to another. Marx view this sort of crisis as a mechanism for bringing about equilibrium.

IV.5 Marxian Analysis of crisis Vs Tugan's Disproportionality Crisis

Tugan rejected Marx's theory of either under consumption or over production and emphasizes that these could be the outcome of disproportionality crisis only. Tugan maintained that fall in consumption by workers and capitalists can't be the origin of crisis in demand for consumption goods. A fall in demand for consumption goods can be compensated by increase in the production of means of production. The means of production or investment demand will make up for fall in demand for the consumption goods.

On the lines proposed by Tugan, assume that $S_{\Delta c}$ and S_{av} are zero in expanded reproduction scheme. Recall the equilibrium condition of the expanded reproduction (given by equation θ below) is reproduced as follows:

$$V_1 + S_{C1} + S_{\Delta c1} + S_{av1} = C_2 + S_{ac2}$$

The equilibrium condition with assumption of $S_{\Delta c} = 0$ and $S_{av} = 0$ boils down to:

$$V_1 + S_{C1} = C_2 + S_{ac2} \dots \dots \dots (2)$$

As we already know that V_1, S_{C1} and C_2 also correspond to simple reproduction and hence, $V_1 + S_{C1} = C_2$ must always be maintained. This would imply that S_{ac2} is zero.

Hence, we have proved by contradiction that if consumption goods demand is curtailed then no accumulation would take place in Department II.

Tugan rejected under consumption crisis as a form of crisis. He argues that if labor and capital are assumed mobile then there can be upshot of production of means of production goods, more labor being employed in Department I while output of Department II remains constant; so case for expanded reproduction scheme can be reconstructed. The increase in production goods is consistent with absolute but smaller increase in consumption goods.

He takes argument to a level where there is only one worker who will be engaged in mass production of new machines and consumption goods for the capitalists. To him, capitalism is run by and for the capitalists. Workers can be displaced by machinery and contraction of consumption by working class would not call for crisis as long as proportions are maintained.

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Total output expands and the proportion made up by means of production grows always larger. The only requisite is that correct proportions must always be maintained.

Tugan has been widely criticized by other economists for the fact that Tugan has taken such an extreme position.

Conrad Schmidt: he argues with Tugan that capitalism can't end. However, opposes him by saying that consumption is enlivening force that keeps production in motion.

Kautsky: Capitalism though equates men and machines but society is and will always remain a society of men. Social relation is of men to men and not of men to machine. Human labor is a value-creating factor and role of human consumption can't be underestimated. Production is and will expand for human consumption.

Louis B. Proudin: Means of production are nothing more than means of production of consumable goods. When demand for consumption is curtailed; then production of means of production is meaningless and if produced is called as 'over production'.

Rosa Luxemburg: Interdependency of consumption and production, as considered by Tugan, is referred to as vulgar economic fantasy by Rosa.

Bukharin: There is a chain of related industries which create market for others and this chain ends when industry produces consumer goods.

Marx favors under consumption theory of crisis, is clear by his statement, ".....cause of all real crisis always remains the poverty and restricted consumption of the masses as compared to the tendency of capitalist production to develop the productive forces in such a way that only the absolute power of consumption of the entire society would be their limit."

Sweezy's formulation of under consumption crisis

Capitalism has inherent tendency to expand capacity to produce consumption goods more rapidly than the demand for consumption goods and hence, crisis of under consumption will follow. This tendency manifests itself in two ways:

Capacity is actually expanded

Capacity creation is a regular and continuous feature of capitalism. This translates into increasing the volume of consumption goods being entering into the market. A point will be reached where supply exceeds demand and sooner or later, production will be curtailed.

Idle Productive forces

Productive forces are not anymore utilized in producing additional capacity. Additional capacity produces demand for goods but is less than the latter, hence making additional capacity creation redundant.

In order to get rich, capitalists are required to do the following:

- ◆ Making as much profit as possible and accumulation of surplus rises as proportion.
- ◆ Investment should be rising proportion of accumulation, where

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accumulation by capital = $S_{ac} + S_{av}$ and investment refers to S_{ac} i.e. addition to constant capital.

- ◆ Consumption is decreasing proportion of surplus value, although capitalists consumption must be increasing ($S_{\Delta c}$ is positive).
- ◆ Investment of wages (S_{av}) is diminishing ratio of total accumulation.

The above four conjectures together imply that the rate of growth of consumption declines relative to rate of growth of means of production.

Capitalist act in a way that following ratio shows a steady decline:

Ratio of Rate of growth of consumption to Rate of growth of means of production

If one looks at this problem from the production/supply side then nature of production process enforces that following ratio remains constant.

Ratio of Rate of growth of output of consumption goods to Rate of growth of means of production

It is thus proved that in the capitalist system, there is inherent tendency for the growth in consumption to lag behind growth in output of consumption goods. Viewed this way, 'under consumption' and 'over production' are opposite sides of same coin. Under consumption is first witnessed in the means of production department and over production in consumption goods.

To conclude, under consumption is a special case of disproportionality between growth of demand for consumption goods and growth of capacity to produce consumption goods. This disproportionality though does not arise from plan-less character of capitalism but from inherent tendencies of capitalism.

Summary

- If there is any disturbance in the circulation process, result is crisis and this sort of disturbance is not specific to capitalism and could erupt in all forms of society including capitalism.
- When all tendencies i.e. those boosting rate of profit and those suppressing rate of profit operate on equal footing, then state has a vital role to play in manipulating outcome. If fall in rate of profit is major tendency then state's intervention would not be able to circumvent crisis.
- If government intervenes in under-consumption crisis by creating effective demand and if boom lasts for long, it would have two effects: tightening labor market and

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rise in real wages. State action to prevent under-consumption crisis creates wage-squeeze crisis.

- Wage-squeeze and under-consumption could not be causes of a general crisis and rather outcome of profitability crisis. Fall in profits would induce capitalists to lower investment demand creating under-consumption and simultaneously, leading in real wages. If fall in rate of profit is dominant tendency then state has no role to play to avoid crisis.
- Tugan proposed disproportionality crisis and argues that only reason for crisis is disproportionality. If production in various branches is maintained in correct proportions, then crisis could never occur.
- Tugan argued that under-consumption is not possible and found production of means of production and consumption goods as perfectly substitutable. Consumption goods' demand and production fall even then means of production's production will continue to rise as capitalists have urge to accumulate and capitalism is for capitalists. Tugan has been criticized for taking such extreme position.
- Sweezy demonstrated two important things: first, rate of growth of production exceeds rate of growth of consumption and second, result of it is overproduction or its equivalent underconsumption.

Exercises

Q1. Crisis is inevitable under capitalism. Explain.

Q2. State has an important role to play in circumventing crises. If yes, explain how.

[hint: possibility theories]

Q3. Can there be a form of crises where in all commodities sell at their true values? Discuss.

[hint: profitability crisis]

Q4. "The only cause of general crisis is disproportionality among various branches of production". Elaborate.

Q5. Crisis emerges when producers are not able to sell their products at their true values. Comment.

[hint: realization crises : underconsumption and disproportionality crises]

Q6. 'Underconsumption and overproduction are flip sides of a same coin'. Explain how it is possible in capitalism?

[hint: sweezy's formulation of underconsumption crisis]

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Question Number	Type of question
7	True or False

Question

- Anything produced will be sold off in the market.
- Boosting of demand by government in monopoly capitalism is effective.
- Wage squeeze is not a cause but result of underconsumption.
- Undertaking production for capitalist is important may it be consumption goods or investment.
- There is an inherent tendency for ratio of rate of growth of means of production to rate of growth of consumption to rise.

Correct Answer / Option(s)

- True
- False
- True
- False
- True

Justification/ Feedback for the correct answer

- The flip side of it is overproduction and it is irrelevant that someone will consume since it has been produced.
- The efforts of government to diminish demand gap would result in higher prices instead of output and hence government can put regulations in place that curtail monopolies.
- Wages rise when government sustain boom in phase of declining investment demand.
- This is Tugan's argument. But this is nothing more than his whim and fancy. Fall in purchasing power of working class has been responsible in shaping up crisis.
- Accumulation implies faster rate of growth of means of production. Appropriation of surplus to consumption falls so as to sustain ever growing accumulation.

Glossary

- Economic Crisis:** Economic crisis refers to a situation when disturbances in the capitalist order become so severe that entire political and economic system is threatened and their smooth functioning has been brought to an end.
- Effective Demand:** when a consumer has both desire and ability to buy then it is referred as effective demand. Effective demand was proposed by JM Keynes and explains that consumer's effective demand fell during great depression. Effective

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demand in one market is constrained by other market. During great depression, demand in goods market was constrained by wage conditions in labor market.

- **Accumulation:** Accumulation refers to ploughing back of profits for expansion of capital base.
- **Falling rate of profit :** Marx formulated Falling rate of profit and explained that rate of profit has a tendency to fall with the rise in capital accumulation.

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