# Financial crisis or crisis of capitalism? [1]

Michel Husson, 2009

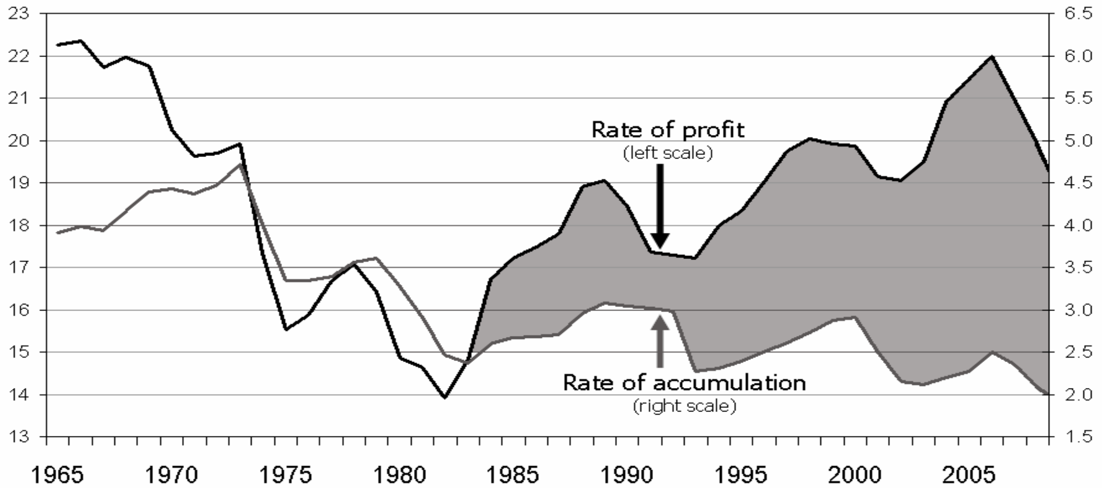
The current crisis originated in the financial arena but quickly spread to all of the so-called real economy. This observation raises two questions. A theoretical question: how to analyze the relationship between finance and the real economy and their responsibility for the crisis? And a more practical question: what are the channels of transmission from one to another and how to reverse financialisation?

## *What is the link between finance and the real economy?*

Very schematically, it is possible to say on this point, that between progressive economists, two theses are opposed according to whether finance is considered as parasitic or functional. In order to discuss these two positions better, a possible starting point is consideration of an essential characteristic of contemporary capitalism. From the neo-liberal turn at the beginning of the 1980s the rate of profit has recovered considerably, but this has not lead to an increase in the rate of accumulation (see diagram). In other words, the extra profits were used for something other than investment.

Manifestly, the "theorem of Schmidt", enunciated by Chancellor Helmut Schmidt at the beginning of the 1980s ("today's profits are tomorrow's investments and the jobs of the day after tomorrow") has not worked. That this behaviour is unprecedented in the history of capitalism has been established and emphasized by many analysts, and is a key element of the critique of financial capitalism.

*Figure 1: Profit and accumulation (USA + UE + Japan)*




Source : Ameco Database, European Commission, http://tinyurl.com/ameco8
Rate of accumulation = growth rate of net capital

An increasing amount of the wealth produced has been absorbed by bank profits and dividends. The first explanation for this phenomenon is that the financial sector extracts profits made by enterprises in the productive sector. This is referred to as parasitic or predatory finance, which implies that the requirements of profitability will continually

[1] English version of Michel Husson: *Crise de la finance ou crise du capitalisme*. In Denknetz Jahrbuch 2009, edition 8, Zürich, pp. 22-28.

grow and exert a growing pressure on business management and particularly on employment. This interpretation contains some truth but it may relieve productive capitalism of responsibility. There would be a "good" capitalism which would be unable to function properly as a result of the puncture made by the "bad" finance. Such a reading grid logically implies that the horizon of an alternative plan could be limited to the regulation of capitalism through relieving the financial pressure that is the source of all the ills, and through this would provide it with the means to function normally.

A variant of this view distinguishes between two measures of profit rates as calculated before or after payment of interest and dividend payments. The rate of capital accumulation is seen as evolving in line with the narrow definition of profit of enterprises, thus implicitly advancing the idea that finance drains away the capital needed for investment. It is a distorted view of the theory of capitalism to make the dynamics of accumulation dependent on the distribution of profits between companies and stockholders. It is opposed both by Marxist theory and conventional theories which postulate that the remuneration of shareholders is justified by their provision of savings and therefore investment.

Another objection to this reading is based on a reality in several countries, and in any case in France; domestic investment is relayed through foreign investment. Analysis on a global scale would show the difference between profit and accumulation to be reduced significantly. In addition to the statistical difficulties that hinder such an assessment, observation of international investment flows shows that they still relate mainly to developed countries, although the share of emerging markets has increased. IMF data show that in 2006 the two superpowers (U.S. and EU) were net exporters of productive capital, but at a level of a small proportion of their private investment, respectively 1% and 3%.

This approach is unsatisfactory because it can not account for the change of capitalism since its entry into the neo-liberal period. The transformation of the financial system must be analyzed through two key trends at work since the early 1980s. The first is the continuing decline in the share of produced wealth that accrues to employees, almost everywhere in the world. Even the IMF and the European Commission are now finding this. It is this decline in the wage share that has led to a dramatic recovery in profit rates from the mid-1980s. But, again, this additional profit has not been used to invest more.

The growing mass of profits not invested was mainly distributed in the form of financial revenue, and here lies the source of the process of financialization. The difference between the profit rate and investment rate is also a good indicator of the degree of financialization. One can also verify that the rise in unemployment and job insecurity is associated with the growth of the financial sphere. Again, the reason is simple: finance has succeeded in capturing most of the productivity gains at the expense of employees by blocking the growth of wages and not sufficiently reducing, in fact increasing, the duration of labour.

The relationship between productive capital and financial capital has profoundly changed. But this has been in the direction of increasing interdependence: we have moved from an economy of debt, where bank credit provides financing to companies to a financialized economy where firms have developed their own financial activities. The requirement of financial profitability is very high, an effect which in turn influences the conditions of exploitation of workers. One can therefore not artificially separate the role of finance and that of the conflict between capital and labour for the distribution of value added. It is not the rise of finance which lowers wages but, conversely, the rise of the share of profits not invested which feeds finance.

If one thinks in terms of the reproduction of capital, then we are facing the following problem. The share of wages has fallen and that of investment stagnated: under these conditions, who will buy production that continues to grow? The solution to this problem relies on the recycling of profits not invested, which is carried through by the redistribution operated by finance.

Financialisation is not an independent factor and it appears as the logical counterpart of the decline in wages and the scarcity of investment opportunities which are profitable enough. Therefore, the rise of social inequalities (within each country and between areas of the world economy) is a constitutive feature of the functioning of contemporary capitalism.

This approach to finance is reinforced through the inclusion of globalization. In the gradual establishment of a global market, the role of finance is to eliminate as much as possible any boundaries to areas of valorisation. The great strength of finance capital is in effect to ignore geographical or sectoral boundaries, because it has the means to quickly pass from one economic zone to another; from one sector to another the movements of capital can now be deployed on a scale greatly enlarged. The function of finance is here to intensify the law of competition and to make the movement of capital more fluid.

The current configuration of the global economy strengthens this mechanism. It is indeed fundamentally unbalanced, since the deficit of the United States is financed by the rest of the world. However, this imbalance contributes to an enormous amount of liquidity in search of maximum profitability which fuels finance and adds to its inherent instability. The main feature of contemporary capitalism does not lie in the opposition between financial capital and productive capital, but the devaluation of work and the hyper-competition between capitals which leads to financialisation.

*Which transmission channels?*

In 1987, a major meltdown led most economists to predict a sharp slowdown in the global economy. The opposite happened: from 1988, developed countries experienced a cycle of dynamic growth. The stock market crash did not transmit to the real economy and, instead, drained the excesses and allowed resetting of the meters to zero. It is after all a classic function of crises to clear the accounts and eliminate lame ducks. A few years later, a housing crisis and major mortgage shock hit Japan, which was presented at the time as the rising power set to conquer world markets. This opened a decade of approximately zero growth, from which the Japanese economy has struggled to emerge.

Finance is more or less independent in different places and times but it is clear that in the current crisis, the transmission to the real economy has been rapid, brutal and universal. Neither Europe nor the emerging countries have avoided the collapse of the mortgage market in the United States. This transmission has worked through several channels:

- restrictions on credit affect both household consumption and corporate investment. This effect was particularly marked in countries like the US and the UK, where household consumption is driven by debt

- devaluation of financial assets and household property will encourage lower consumption through the wealth effect;
- the general uncertainty weighs on consumption and investment behaviour,
- the housing crisis contributes in its own right to the general economic downturn;
- public spending to support the banking system represents considerable sums which will require spending cuts or tax increases;
- last but not least, the slowdown is spreading to the entire world economy through trade and investment .

All these mechanisms currently at work are combined with other dimensions of the crisis to extend its impact well beyond the financial sphere. There is no watertight division between finance and the real economy, because finance is a cornerstone of neo-liberal capitalism. This also means that the very foundations of its current operation will be jeopardized by the current crisis. For example, the growth model of the United States is based on a double deficit; the foreign trade deficit and the internal savings deficit. In both cases, finance plays a key role in managing these imbalances: internally it has made possible over-indebtedness; externally it has sustained the balance of payments through capital inflows. But if the financial sector collapses, it is the basis of this mode of growth that will be challenged: household debt is now blocked, and capital inflows are no longer guaranteed. Therefore, the financial crisis will lead to a lasting slowdown in growth in the United States which will be communicated to the rest of the world.

### *The nature of the crisis*

This interpretation of the crisis opposes certain dogmatic interpretations which lay a claim to Marx and allot a central role to the famous law of the falling rate of profit. However, all empirical evidence shows that the rate of profit has recovered sharply in the major capitalist countries. Without twisting the measurement of the rate of profit to show it falling contrary to the evidence, it is necessary to think about a crisis resulting from an overflow of profit. Against this backdrop, a debate is growing on the characterization of the crisis: overproduction, over-accumulation, under-consumption? Contributions to this debate are often lengthy comments of Marx's Capital instead of a concrete analysis of the current crisis. It is no doubt necessary to return to more detailed discussion of this tedious debate, but it is especially important to stress here two dimensions of the crisis which it obscures.

It results primarily from the exploitation of workers worldwide. Overall, the main characteristic of contemporary capitalism is a general trend toward higher rates of exploitation. From this point of view, capitalism has managed to restore its rate of profit but it faced a problem of realisation which appeared in the mid-1980s. This contradiction was managed in two ways: by increasing inequality which generated alternatives to consumption out of wages and by a headlong rush into debt distress. In both cases, the role of "finance" is decisive in ensuring the recycling of capital gains income to stockholders, and supporting the rush towards debt.

Capitalism has been caught short by this contradiction, and this is the meaning of this crisis. But we must go further and ask the question why capitalism is now investing a smaller proportion of its profits. We can once again see the pressure of finance, but this would not be exercised with the same force if capitalism had sufficient opportunities for profitable investments. It is here that the systemic character of the crisis is located, at a deeper level, and involving the vital springs of this mode of production. The source of this crisis is fundamentally the widening gap between the social needs of humanity and the criteria specific to capitalism. Social demand is focused on goods that are not likely to be produced with maximum efficiency. The productivity gains allowed by new technologies and innovation lead to a choice (based on profitability in production) which is less in line with social demand and which, consequently, is not sufficiently profitable in the market.

This gap is in two main dimensions. The first, in developed countries, is the shift in demand from manufactured goods to services which are associated with lower productivity growth and hence lower profit outlook. No outlet has taken over at a scale sufficient to play the same role as the automotive sector in the earlier Fordist phase. The second dimension is the result of geo-economics and globalization: it tends to create a global market, i.e. an enlarged space for valorisation. The lower levels of productivity of less advanced sectors are directly confronted with profitability requirements aligned with the performance of countries or companies which are more efficient. The resulting supplantation means that a number of producers - and hence the social needs that they could meet - are no longer viable based on the criteria of hyper-profitability that they face.

Under these conditions, the reproductive system goes through a double movement of expansion in the field of goods and refusal to respond to needs which are not profitable. Contemporary capitalism has met the conditions of optimal functioning from its point of view. Rather than improving social welfare, perfect competition, free of regulations, rigidities and other distortions, shows a total lack of legitimacy, since social regression is explicitly claimed as the main condition for success of the system. In this framework, finance is not only the compensation for the increased exploitation of workers, it is also an outlet for capital in search of maximum profitability. The excessive profitability requirement it imposes on the real economy in turn reinforces the low buoyancy of investment and social inequality as a condition of reproduction of the system.

This analysis leads to two general conclusions. The first is that capitalism has been overtaken by its contradictions and sees itself reduced to the situation that it was in after the recession of 1974-75. For over 25 years, it existed entirely on credit and is now faced with deadlines with which it cannot cope. The bank failure is the symbol of its own bankruptcy, and it has no other alternative. Under these conditions, and this is the second conclusion, regulation of finance would be a useful remedy, but that does not address the root causes. Financialisation feeds on the declining wage share and imbalances in the global economy. To deflate finance therefore requires closing the two valves that feed it, which implies a different distribution of wealth and another organization of the world economy, both perspectives absolutely foreign to capital.