The Financialization of Capital and the Crisis

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With the benefit of hindsight, few now doubt that the housing bubble that induced most of the recent growth of the U.S. economy was bound to burst or that a general financial crisis and a global economic slowdown were to be the unavoidable results. Warning signs were evident for years to all of those not taken in by the new financial alchemy of high-risk debt management, and not blinded, as was much of the corporate world, by huge speculative profits. This can be seen in a series of articles that appeared in this space: “The Household Debt Bubble” (May 2006), “The Explosion of Debt and Speculation” (November 2006), “Monopoly-Finance Capital” (December 2006), and “The Financialization of Capitalism” (April 2007). In the last of these we wrote:

So crucial has the housing bubble been as a counter to stagnation and a basis for financialization, and so closely related is it to the basic well-being of U.S. households, that the current weakness in the housing market could precipitate both a sharp economic downturn and widespread financial disarray. Further rises in interest rates have the potential to generate a vicious circle of stagnant or even falling home values and burgeoning consumer debt service ratios leading to a flood of defaults. The fact that U.S. consumption is the core source of demand for the world economy raises the possibility that this could contribute to a more globalized crisis....

In the September 2006 *Global Financial Stability Report* the IMF executive board directors expressed worries that the rapid growth of hedge funds and credit derivatives could have a systematic impact on financial stability, and that a slowdown of the U.S. economy and a cooling of its housing market could lead to greater “financial turbulence,” which could be “amplified in the event of unexpected shocks.” The whole context is that of a financialization so out of control that unexpected and severe shocks to the system and resulting financial contagions are looked upon as inevitable.1

This scenario, which was already beginning to be played out at the time that the above passage was written, of stagnant and falling home prices, a flood of defaults, and a global economic crisis due to financial contagion and a drop in U.S. consumption, has now become a concrete reality. Since the collapse of the subprime mortgage market in July 2007, financial distress and panic have spread uncontrollably not only across countries but also across financial markets themselves, infecting one sector after another: adjustable rate mortgages, commercial paper (unsecured short-term corporate debt), bond insurers, commercial mortgage lending, corporate bonds, auto loans, credit cards, and student loans.

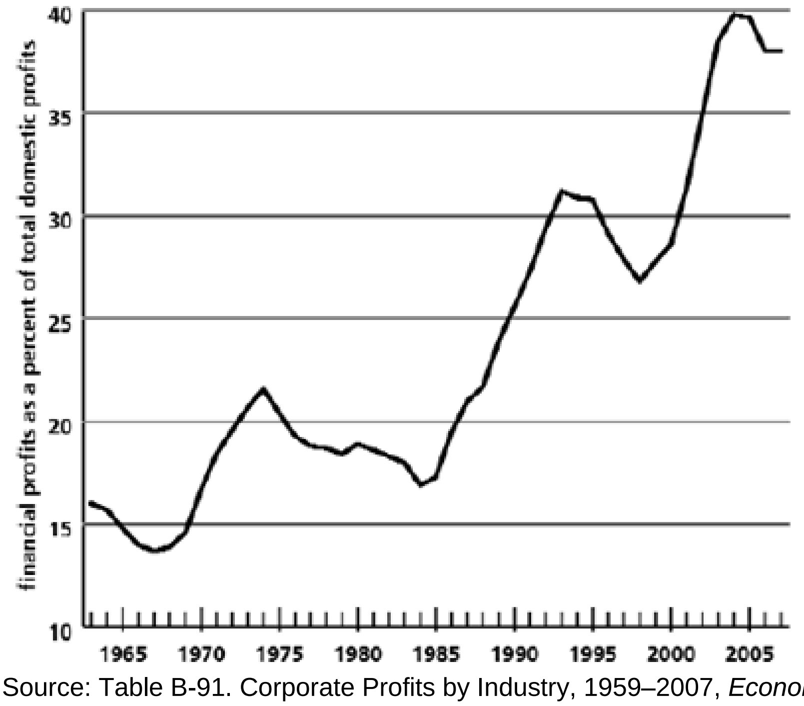
Banks, hedge funds, and money markets are all under assault. Given the already weak condition of U.S. production, it did not take long for this financial unraveling to be registered in negative numbers in the “real” economy: falling employment, weakening consumption and investment, and decreasing production and profits. Most business and economic analysts now believe that a full blown recession is ahead both for the United States and the world economy, and may already have begun. “As of right now,” former Federal Reserve Board Chairman Alan Greenspan stated on February 25, 2008, “U.S. economic growth is zero. We are at stall speed.”2

What we will argue here is that this is not just another massive credit crunch of the kind so familiar in the history of capitalism, but signals a new phase in the development of the contradictions of the system, which we have labeled “monopoly-finance capital.” The bursting of two major financial bubbles in seven years in the citadel of capitalism points to a crisis of financialization, or of the progressive shift in gravity from production to finance that has characterized the economy over the last four decades.

What Paul Sweezy just over a decade ago called “the financialization of the capital accumulation process” has been the main force lifting economic growth since the 1970s.3 The transformation in the system that this has brought about is reflected in the rapid growth since the 1970s of financial profits as a percent of total profits (see chart 1). The fact that such financialization of capital appears to be taking the form of bigger and bigger bubbles that burst more frequently and with more devastating effect, threatening each time a deepening of stagnation—i.e., the condition, endemic to mature capitalism, of slow growth, and rising excess capacity and unemployment/underemployment—is thus a development of major significance.

In order to address this issue we will first examine the evolution of the immediate crisis identified with the bursting of the housing bubble. Only then will we turn to the question of the long-run trend of accumulation, namely the stagnation-financialization dynamic, where the larger historical conditions of the present crisis are to be found.

Chart 1. Financial profits as a percent of total profits (five-year moving average)



Source: Table B-91. Corporate Profits by Industry, 1959–2007, *Economic Report of the President, 2008.*

The Five Phases of a Bubble

Although the massive stock market decline in 2000 seemed to presage a serious economic decline, business losses were cushioned and wider economic disruptions were curtailed by a real estate bubble—leading to only a relatively minor recession in 2001. Financial analyst Stephanie Pomboy at MacroMavens aptly dubbed this in 2002 as “The Great Bubble Transfer,” in which a speculative bubble in the home mortgage market miraculously compensated for the bursting of the stock market bubble.4 Fed by low interest rates and changes in reserve requirements of banks (which made more funds available) capital flowed massively into the housing market, mortgage lending skyrocketed, housing prices soared, and hyperspeculation soon set in.

What occurred followed the basic pattern of speculative bubbles throughout the history of capitalism, as famously depicted by Charles Kindleberger in *Manias, Panics, and Crashes*: a novel offering, credit expansion, speculative mania, distress, and crash/panic.5

Novel Offering

A novel offering may be a new market, a revolutionary new technology, an innovative product, etc.6 The novel offering in this case was the “securitization” of mortgage loans through a new financial instrument known as the collateralized debt obligation (CDO). Since the 1970s banks had been pooling individual mortgage loans, using the cash flow provided by these loans to generate residential mortgage-backed securities. These securitized loans in a later development were themselves repackaged in the form of CMOs (“Collateralized Mortgage Obligations”). The CMOs were comprised of what were known as “tranches,” or groupings of income streams from mortgages divided so as to pay off the principal of each tranche’s debt in sequence—the highest tranche, first, and so on. In the 1990s, and especially at the end of the decade, banks began to construct CDOs, which mixed together low-risk, middle-risk, and high-risk (subprime) mortgages, along with other types of debt.

The tranches now represented risk of default, with the lowest tranche absorbing all defaults before the next higher tranche, and so on. The three major credit agencies gave the higher tranches of these new CDOs investment-grade ratings. (An investment grade bond is one judged likely enough to meet payment obligations that banks are allowed to invest in them—a bond below investment grade is a junk bond.) The assumption was that geographical and sector dispersion of the loan portfolio and the “slicing and dicing” of risk would convert all but the very lowest of the tranches of these investment vehicles into safe bets. In many cases the highest (and largest) tranche of such CDOs obtained the best possible rating (“AAA”—equivalent to the rating of the obligations of the U.S. government) through the device of being “insured” against default by a bond-insuring company that itself had been granted AAA ratings. All of this created a vastly expanded market for mortgage lending. This quickly encompassed so-called “subprime” borrowers with poor credit histories and/or low incomes previously outside the mortgage market. And by obtaining high credit ratings for the resulting instruments, the bank creators of these securities obtained the ability readily to dispose of them throughout the new global financial markets.

Crucial to the housing bubble were off-balance-sheet conduits set up by banks, known as structured investment vehicles (SIVs)—themselves virtual banks—designed to hold CDOs. These special entities financed their purchases of CDOs by drawing on the commercial paper market for short-term funds. This meant that they were borrowing short-term funds (through the issue of "asset-backed commercial paper") to invest in long-term securities. In order to reassure investors, "credit default swap" arrangements were made with banks, involving big banks like Bank of America, whereby SIVs (in this case the swap buyers) made quarterly payments in return for banks (the swap sellers) promising to make a large payment if the SIVs found their assets declining and their credit drying up and were forced into default. This along with other factors had the effect of leaving banks potentially exposed to risks that they had supposedly transferred elsewhere.7

Credit Expansion

An expansion of credit—which means people or corporations are taking on more debt—is required to feed any asset price bubble. In the housing bubble extremely low interest rates following the bursting of the stock market bubble and changes in reserve requirements of banks expanded the credit available to borrowers across the board, regardless of their credit history. Beginning in January 2001, the Federal Reserve Board lowered interest rates in twelve successive rate cuts, reducing the key federal funds rate from 6 percent down to a post-Second World War low of 1 percent by June 2003.8

In the resulting housing bubble cheap financing expanded the number of mortgage borrowers despite the increasing prices of houses. The combination of extraordinarily low interest rates and longer mortgages resulted in affordable monthly payments even while prices were rapidly increasing. If such monthly payments were still unaffordable—as they often were given that real wages had stagnated for thirty years and entry level jobs rarely paid more than close to the minimum wage—means were devised to lower the initial payments yet further. This often took the form of adjustable rate mortgages with low "teaser" interest rates, which would be reset after a specified introductory period, usually three to five years or less. Paying almost no interest and making no capital payments, new buyers could now "afford" homes at even higher prices.

Unsophisticated home buyers were readily gulled by the overpowering real estate boom euphoria, and easily led to believe that the continual rise in the prices of their homes would allow them to refinance their mortgages when teaser rates expired. Many subprime mortgage loans amounted to 100 percent of the appraised value of the house. The originators of the subprime loans had every incentive to generate and bundle together as many of these loans as possible since the repackaged loans were quickly sold off to others. And, of course, the rapidly inflating home purchase costs covered by these subprime mortgages included a rich rake-off in the form of commissions and fees to a vast predatory swarm of intermediaries in the brokerage and mortgage generating "industry." "The amount of subprime mortgages issued and imbedded in Mortgage Backed Securities shot up from $56 billion in 2000 to $508 billion at the peak in 2005."9

Speculative Mania

Speculative mania is characterized by a rapid increase in the quantity of debt and an equally rapid decrease in its quality. Heavy borrowing is used to buy up financial assets, not based on the income streams they will generate but merely on the assumption of increasing prices for these assets. This is what economist Hyman Minsky famously called "Ponzi finance" or hyperspeculation.10 CDOs, with their exposure to subprime mortgages or financial "toxic waste," increasingly took this classic form.

Not just mortgage lenders and subprime borrowers were caught up in the frenzy. A growing crowd of real estate speculators got into the business of buying houses in order to sell them off at higher prices. Many homeowners also began to view the rapid increase in the value of their homes as natural and permanent, and took advantage of low interest rates to refinance and withdraw cash value from their homes. This was a way to maintain or increase consumption levels despite stagnant wages for most workers. At the height of the bubble new mortgage borrowing increased by $1.11 trillion between October and December 2005 alone, bringing outstanding mortgage debt as a whole to $8.66 trillion, equal to 69.4 percent of U.S. GDP.11

Distress

Distress marks an abrupt change in the direction of the financial market often resulting from some external event. The housing bubble was first pricked in 2006 due to rising interest rates, which caused a reversal in the direction of housing prices in the hot subprime regions, primarily California, Arizona, and Florida. Borrowers who had been depending on double-digit increases in home prices and very low interest rates to refinance or sell homes before the adjustable rate mortgages were reset were suddenly confronted with falling home prices and mortgage payments that were ratcheting (or would soon ratchet) upwards. Investors began to worry that the cooling down of the housing market in some regions would spread to the mortgage market as a whole and infect the overall economy. As an indicator of such distress, credit debt swaps designed to protect investors and used to speculate on credit quality, increased globally by 49 percent to cover a notional $42.5 trillion in debt in the first half of 2007.12

Crash and Panic

The final stage in a financial bubble is known as crash and panic, marked by a rapid selling off of assets in a “flight to quality” (i.e., liquidity). Cash once again becomes king. The initial crash that shook the market occurred in July 2007 when two Bear Stearns hedge funds that held nearly $10 billion in mortgage-backed securities imploded. One lost 90 percent of its value, while the other melted down completely. As it became apparent that these hedge funds were unable to figure out the actual value of their holdings numerous banks, in Europe and Asia as well as the United States, were forced to acknowledge their exposure to toxic subprime mortgages. A severe credit crunch ensued as fear spread among financial institutions, each of which was unsure as to the level of financial toxic waste the other was holding. The seepage of the credit crunch into the commercial paper market cut off the main source of funding for the bank-sponsored SIVs. This brought to the fore the very heavy risk exposure of some of the big banks arising from credit default swaps. A key event was the failure and subsequent bailing out and nationalization of the British mortgage lender Northern Rock, which in September 2007 was the first British bank in over a century to experience a bank run, with customers lining up to withdraw their savings accounts. U.S. bond insurers also began to implode—a development particularly threatening to capital—due to their underwriting of credit-default swaps on mortgage-backed securities.13

The financial panic quickly spread around the globe, reflecting the fact that international investors were also heavily tied into speculation on U.S. mortgage-backed securities. Widespread fears emerged that world economic growth would drop to the 2.5 percent or lower level that for economists defines a world recession.14 Much of the fear that swept through global financial markets was due to a system so complex and opaque that no one knew where the financial toxic waste was buried. This led to a stampede into U.S. Treasury bills and a drastic decrease in lending.

By January 19, 2008, the *Wall Street Journal* openly declared that the financial system had entered “The Panic Stage,” referring to Kindelberger’s model in *Manias, Panics, and Crashes*. The Federal Reserve Board responded in its lender of last resort function by pouring liquidity back into the system, drastically lowering the federal funds rate from 4.75 percent in September to 3 percent in January with more interest rate cuts expected to come. The federal government stepped in with a $150 billion stimulus package. Nothing, however, has served, as of this writing (in early March 2008), to halt the crisis, which is based in the insolvency of much of the multi-trillion dollar mortgage market, with new shocks to follow as millions of adjustable rate mortgages see jumps in interest rates. Above all, the end of the housing bubble has undermined the financial condition of already hard-pressed, heavily indebted U.S. consumers, whose purchases equal 72 percent of GDP.

How serious the economic deceleration will be in the end is still unknown. Financial analysts suggest that house prices must fall on average by something like 20–30 percent, and much more in some regions, to get back in line with historical trends.15 The decline in U.S. housing prices experienced an accelerated decline in the fourth quarter of 2007.16 That plus the fact that consumers are being hard hit by other problems such as rising fuel and food prices guarantees a serious slowdown. Some observers now refer to a “bubble cycle” and look to another bubble as the only way to avert catastrophe and quickly restore growth to the economy.17 Others see a period of persistently weak growth.

One thing is certain. Large capitalist interests are relatively well-placed to protect their investments in the downswing through all sorts of hedging arrangements and can often call on the government to bail them out. They also have a myriad of ways of transferring the costs to those lower down on the economic hierarchy. Losses will therefore fall disproportionately on small investors, workers, and consumers, and on third world economies. The end result, as in all such episodes in the history of the system, will be increased economic and financial sector concentration on both the national and global scales.

A Crisis of Financialization

Little more can be said at the moment about the evolution of the downturn itself, which will still have to work its way through the system. From a long-term historical perspective, however, these events can be seen as symptomatic of a more general crisis of financialization, beyond which lurks the specter of stagnation. It is by exploring these wider and deeper issues rooted in class-based production that we can throw the light on the significance of the above developments for capital accumulation and the future of capitalist class society.

Numerous commentators have castigated the U.S. economy for its “monstrous bubble of cheap credit...with one bubble begetting another”—in the words of Stephen Roach, chairman of Morgan Stanley Asia. Elsewhere Roach has observed that “America’s bubbles have gotten bigger, as have the segments of the real economy they have infected.” Household debt has risen to 133 percent of disposable personal income, while the debt of financial corporations has hit the stratosphere, and government and non-financial corporate debt have been steadily increasing.18 This huge explosion in debt—consumer, corporate, and government—relative to the underlying economy (equal to well over 300 percent of GDP by the housing bubble's peak in 2005) has both lifted the economy and led to growing instability.19

Mainstream commentators often treat this as a national neurosis tied to a U.S. addiction to high consumption, high borrowing, and vanishing personal savings, made possible by the infusion of capital from abroad, itself encouraged by the hegemony of the dollar. Radical economists, however, have taken the lead in pointing to a structural transformation in the capital accumulation process itself associated with the decades-long historical process—now commonly called financialization—in which the traditional role of finance as a helpful servant to production has been stood on its head, with finance now dominating over production.

The issue of financialization of the capital accumulation process was underscored a quarter-century ago in *Monthly Review* by Harry Magdoff and Paul Sweezy in an article on "Production and Finance." Starting with a theory (called the "stagnation thesis")20 that saw financial explosion as a response to the stagnation of the underlying economy, they argued that this helped to "offset the surplus productive capacity of modern industry" both through its direct effect on employment and indirectly through the stimulus to demand created by an appreciation of assets (now referred to as the "wealth effect").21 But the question naturally arose: Could such a process continue? They answered:

From a structural point of view, i.e., given the far-reaching independence of the financial sector discussed above, financial inflation of this kind can persist indefinitely. But is it not bound to collapse in the face of the stubborn stagnation of the productive sector? Are these two sectors really that independent? Or is what we are talking about merely an inflationary bubble that is bound to burst as many a speculative mania has done in the past history of capitalism?

No assured answer can be given to these questions. But we are inclined to the view that in the present phase of the history of capitalism—barring a by no means improbable shock like the breakdown of the international monetary and banking system—the coexistence of stagnation in the productive sector and inflation in the financial sector can continue for a long time.22

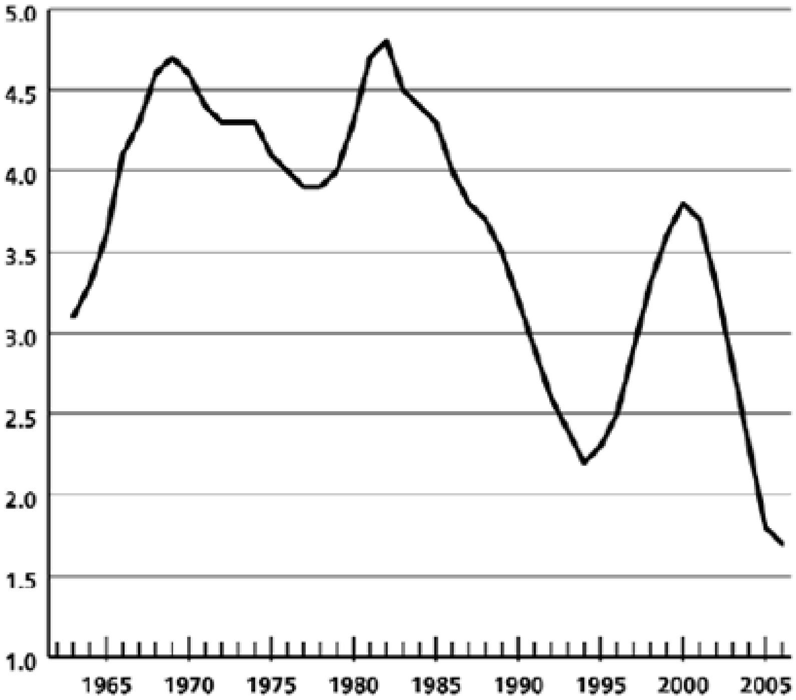
At the root of the financialization tendency, Magdoff and Sweezy argued, was the underlying stagnation of the real economy, which was the normal state of modern capitalism. In this view, it was not stagnation that needed explaining so much as periods of rapid growth, such as the 1960s.

Mainstream economists have paid scant attention to the stagnation tendency in the mature economies. In received economic ideology rapid growth is considered to be an intrinsic property of capitalism as a system. Confronted with what looks like the onset of a major economic slowdown we are thus encouraged to see this as a mere cyclical phenomenon—painful, but self-correcting. Sooner rather than later a full recovery will occur and growth will return to its normal fast-pace.

There is, however, a radically different economic view, of which Magdoff and Sweezy were among the chief representatives, that suggests that the normal path of the mature capitalist economies, such as those of the United States, the major Western European countries, and Japan, is one of stagnation rather than rapid growth. In this perspective, today's periodic crises, rather than merely constituting temporary interruptions in a process of accelerated advance, point to serious and growing long-term constraints on capital accumulation.

A capitalist economy in order to continue to grow must constantly find new sources of demand for the growing surplus that it generates. There comes a time, however, in the historical evolution of the economy when much of the investment-seeking surplus generated by the enormous and growing productivity of the system is unable to find sufficient new profitable investment outlets. The reasons for this are complex having to do with (1) the maturation of economies, in which the basic industrial structure no longer needs to be built up from scratch but simply reproduced (and thus can be normally funded out of depreciation allowances); (2) the absence for long periods of any new technology that generates epoch-making stimulation and transformation of the economy such as with the introduction of the automobile (even the widespread use of computers and the Internet has not had the stimulating effect on the economy of earlier transformative technologies); (3) growing inequality of income and wealth, which limits consumption demand at the bottom of the economy, and tends to reduce investment as unused productive capacity builds up and as the wealthy speculate more with their funds instead of investing in the "real" economy—the goods and services producing sectors; and (4) a process of monopolization (oligopolization), leading to an attenuation of price competition—usually considered to be the main force accounting for the flexibility and dynamism of the system.23

Chart 2. Net private non-residential fixed investment as a percent of GDP (5-year moving average)



Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 5.2.5. Gross and Net

Domestic Investment by Major Type, Annual Data 1929-2006; *Economic Report of the President, 2008*, Table B-1. Gross Domestic Product, 1959-2007.

Historically, stagnation made its presence felt most dramatically in the Great Depression of the 1930s. It was interrupted by the economic stimulus provided by the Second World War and by the exceptionally favorable conditions immediately after the war in the so-called "Golden Age." But as the favorable conditions waned stagnation resurfaced in the 1970s. Manufacturing capacity utilization began its secular decline that has continued to the present, averaging only 79.8 percent in the 1972–2007 period (as compared to an average of 85 percent in 1960–69). Partly as a result net investment has faltered (see chart 2).24

The classical role of net investment (after accounting for replacing depreciated equipment) in the theory of capitalist development is clear. At the firm level, it is only net investment that absorbs investment-seeking surplus corresponding to the undistributed (and untaxed) profits of firms—since the remainder of gross investment is replacement investment covered by capital consumption allowances. As economist Harold Vatter observed in an article entitled "The Atrophy of Net Investment" in 1983,

On the level of the representative individual enterprise, the withering away of net investment spells approaching termination of the historical and deeply rooted raison d'être of the non-financial firm: accumulation of capital. In consequence, undistributed accounting profits, if not taxed away, would lack the traditional offsets [effective demand in the form of net investment], at least in a closed economy.25

It was netinvestment in the private sector that was once the major driver of the capitalist economy, absorbing a growing economic surplus. It was relatively high net private non-residential fixed investment (together with military-oriented government spending) that helped to create and sustain the "Golden Age" of the 1960s. The faltering of such investment (as a percent of GDP) in the early 1970s (with brief exceptions in the late 1970s–early 1980s, and late 1990s), signaled that the economy was unable to absorb all of the investment-seeking surplus that it was generating, and thus marked the onset of deepening stagnation in the real economy of goods and services.

The whole problem has gotten worse over time. Nine out of the ten years with the lowest net non-residential fixed investment as a percent of GDP over the last half century (up through 2006) were in the 1990s and 2000s. Between 1986 and 2006, in only one year—2000, just before the stock market crash—did the percent of GDP represented by net private non-residential fixed investment reach the *average* for 1960–79 (4.2 percent). This failure to invest is clearly not due to a lack of investment-seeking surplus. One indicator of this is that corporations are now sitting on a mountain of cash—in excess of $600 billion in corporate savings that have built up at the same time that investment has been declining due to a lack of profitable outlets.26

What has mainly kept things from getting worse in the last few decades as a result of the decline of net investment and limits on civilian government spending has been soaring finance. This has provided a considerable outlet for economic surplus in what is called FIRE (finance, insurance, and real estate), employing many new people in this non-productive sector of the economy, while also indirectly stimulating demand through the impact of asset appreciation (the wealth effect).

Aside from finance, the main stimulus to the economy, in recent years, has been military spending. As empire critic Chalmers Johnson noted in the February 2008 *Le Monde Diplomatique*:

The Department of Defense's planned expenditures for the fiscal year 2008 are larger than all other nations' military budgets combined. The supplementary budget to pay for the current wars in Iraq and Afghanistan, not part of the official defense budget, is itself larger than the combined military budgets of Russia and China. Defense-related spending for fiscal 2008 will exceed $1 trillion for the first time in history....Leaving out President Bush's two on-going wars, defense spending has doubled since the mid-1990s. The defense budget for fiscal 2008 is the largest since the second world war.27

But, even the stimulus offered by such gargantuan military spending is not enough today to lift U.S. capitalism out of stagnation. Hence, the economy has become more and more dependent on financialization as the key vehicle of growth.

Pointing in 1994 to this dramatically changed economic condition in a talk to Harvard economic graduate students, Sweezy stated:

In the old days finance was treated as a modest helper of production. It tended to take on a life of its own and generate speculative excesses in the late stages of business cycle expansions. As a rule these episodes were of brief duration and had no lasting effects on the structure and functioning of the economy. In contrast, what has happened in recent years is the growth of a relatively independent financial sector, not in a period of overheating but on the contrary in a period of high-level stagnation (high-level because of the support provided to the economy by the militarily oriented public sector) in which private industry is profitable but lacks incentives to expand, hence stagnation of private real investment. But since corporations and their shareholders are doing well and, as always, are eager to expand their capital, they pour money into the financial markets, which respond by expanding their capacity to handle these growing sums and offering attractive new kinds of financial instruments. Such a process began in the 1970s and really took off in the 1980s. By the end of the decade, the old structure of the economy, consisting of a production system served by a modest financial adjunct, had given way to a new structure in which a greatly expanded financial sector had achieved a high degree of independence and sat on top of the underlying production system. That, in essence, is what we have now.28

From this perspective, capitalism in its monopoly-finance capital phase has become increasingly reliant on the ballooning of the credit-debt system in order to escape the worst aspects of stagnation. Moreover, nothing in the financialization process itself offers a way out of this vicious spiral. Today the bursting of two bubbles within seven years in the center of the capitalist system points to a crisis of financialization, behind which lurks deep stagnation, with no visible way out of the trap at present other than the blowing of further bubbles.

Is Financialization the Real Problem or Merely a Symptom?

The foregoing argument leads to the conclusion that stagnation generates financialization, which is the main means by which the system continues to limp along at present. But it needs to be noted that recent work by some radical economists in the United States has pointed to the diametrically opposite conclusion: that financialization generates stagnation. In this view it is financialization rather than stagnation that appears to be the real problem.

This can be seen in a November 2007 working paper of the Political Economy Research Institute written by Thomas Palley, entitled “Financialization: What It Is and Why It Matters.” Palley notes that “the era of financialization has been associated with generally tepid economic growth....In all countries except the U.K., average annual growth fell during the era of financialization that set in after 1979. Additionally, growth also appears to show a slowing trend so that growth in the 1980s was higher than in the 1990s, which in turn was higher than in the 2000s.” He goes on to observe that “the business cycle generated by financialization may be unstable and end in prolonged stagnation.” Nevertheless, the main thrust of Palley’s argument is that this “prolonged stagnation” is an outgrowth of financialization rather than the other way around. Thus he contends that such factors as the “wage stagnation and increased income inequality” are “significantly due to changes wrought by financial sector interests.” The “new business cycle” dominated by “the cult of debt finance” is said to lead to more volatility arising from financial bubbles. Thus “financialization may render the economy prone to debt-deflation and prolonged recession.” Palley calls this argument the “financialization thesis.”29

There is no doubt that a prolonged deep stagnation could well emerge at the end of a financial bubble, i.e., with the waning of a period of rapid financialization. After all, this is what happened in Japan following the bursting of its real estate-stock market asset bubble in 1990.30 The analysis that we have presented here, however, would suggest that an economic malaise of this kind is most usefully viewed as a *crisis of financialization* rather than attributable to the negative effects of financialization on the economy, as suggested by Palley. The problem is that the financialization process has stalled and with it the growth it generated.

The point we are making here can be clarified by looking at another (October 2007) working paper (also from the Political Economy Research Institute) by economist Özgür Orhangazi on the subject of “Financialization and Capital Accumulation in the Non-Financial Corporate Sector.” Orhangazi argues that “increased financial investment and increased financial profit opportunities crowd out real investment by changing the incentives of the firm managers and directing funds away from real investment.” Noting that “the rate of capital accumulation [referring to net nonresidential fixed investment by non-financial corporations] has been relatively low in the era of financialization,” Orhangazi sees this as due to “increased investment in financial assets,” which “can have a ‘crowding out’ effect on real investment”: stagnation then is converted from a cause (as in the stagnation thesis) to an effect (the financialization thesis).31

Yet, the idea of the “crowding out” of investment by financial speculation makes little sense, in our view, when placed in the present context of an economy characterized by rising excess capacity and vanishing net investment opportunities. There are just so many profitable outlets for capital in the real economy of goods and services. A very narrow limit exists with regard to the number of profit-generating opportunities associated with the creation of new or expanded automobile or appliance manufacturers, hair salons, fast food outlets, and so on. Under these circumstances of a capital accumulation process that lacks profitable outlets and constantly stalls, the amassing of more and more debt (and the inflation of asset prices that this produces) is a powerful lever, as we have seen, in stimulating growth. Conversely any slowdown in the ballooning of debt threatens that growth. This is not to say that debt should be regarded as a cure-all. To the contrary, for the weak underlying economy of today no amount of debt stimulus is enough. It is in the nature of today's monopoly-finance capital that it "tends to become addicted to debt: more and more is needed just to keep the engine going."32

Still, as important as financialization has become in the contemporary economy, this should not blind us to the fact that the real problem lies elsewhere: in the whole system of class exploitation rooted in production. In this sense financialization is merely a way of compensating for the underlying disease affecting capital accumulation itself. As Marx wrote in *Capital*, "The superficiality of political economy shows itself in the fact that it views the expansion and contraction of credit as the cause of the periodic alterations of the industrial cycle, while it is a mere symptom of them." Despite the vast expansion of credit-debt in the capitalism of today, it remains true that the real barrier to capital is capital itself: manifested in the tendency toward overaccumulation of capital.

The well-meaning critique of financialization advanced by Palley, Orhangazi, and others on the left is aimed at the re-regulation of the financial system, and elimination of some of the worst aspects of neoliberalism that have emerged in the age of monopoly-finance capital. The clear intention is to create a new financial architecture that will stabilize the economy and protect wage labor. But if the foregoing argument is correct, such endeavors to re-regulate finance are likely to fail in their main objectives, since any serious attempt to reign in the financial system risks destabilizing the whole regime of accumulation, which constantly needs financialization to soar to ever higher levels.

The only things that could conceivably be done within the system to stabilize the economy, Sweezy stated at Harvard in 1994, would be greatly to expand civilian state spending in ways that genuinely benefited the population; and to carry out a truly radical redistribution of income and wealth of the kind "that Joseph Kennedy, the founder of the Kennedy dynasty" referred to "in the middle of the Great Depression, when things looked bleakest"—indicating "that he would gladly give up half his fortune if he could be sure the other half would be safe." Neither of these radical proposals of course is on the agenda at present, and the nature of capitalism is such that if a crisis ever led to their adoption, every attempt would be made by the vested interests to repeal such measures the moment the crisis had passed.33

The hard truth of the matter is that the regime of monopoly-finance capital is designed to benefit a tiny group of oligopolists who dominate both production and finance. A relatively small number of individuals and corporations control huge pools of capital and find no other way to continue to make money on the required scale than through a heavy reliance on finance and speculation. This is a deep-seated contradiction intrinsic to the development of capitalism itself. If the goal is to advance the needs of humanity as a whole, the world will sooner or later have to embrace an alternative system. There is no other way. (March 5, 2008)

Notes

1. John Bellamy Foster, "Financialization of Capitalism," *Monthly Review* 58, no. 11 (April 2007): 8–10. See also John Bellamy Foster, "The Household Debt Bubble," *Monthly Review* 58, no. 1 (May 2006): 1–

11, and "Monopoly-Finance Capital," *Monthly Review* 58, no. 7 (December 2006); and Fred Magdoff, "The Explosion of Debt and Speculation," *Monthly Review* 58, no. 6 (November 2006), 1–23.

2. "U.S. Recovery May Take Longer than Usual: Greenspan," *Reuters*, February 25, 2008.

3. Paul M. Sweezy, "More (or Less) on Globalization," *Monthly Review* 49, no. 4 (September 1997): 3.

4. Stephanie Pomboy, "The Great Bubble Transfer," MacroMavens, April 3, 2002, http:// www.macromavens.com/reports/the_great_bubble_transfer.pdf; Foster, "The Household Debt Bubble," 8–10.

5. The following discussion of the five phases of the housing bubble relies primarily on the following sources: Juan Landa, "Deconstructing the Credit Bubble," *Matterhorn Capital Management Investor Update*, 3rd Quarter 2007, http://www.matterhorncap.com/pdf/3q2007.pdf., and "Subprime Collapse Part of Economic Cycle," *San Antonio Business Journal*, October 26, 2007, and Charles P. Kindelberger and Robert Aliber, *Manias, Panics, and Crashes* (Hokoben, New Jersey: John Wiley and Sons, 2005).

6. In the analysis of financial bubbles that Charles Kindelberger provided based on the earlier theory of financial instability introduced by Hyman Minsky, the phase in the bubble associated here with a "novel offering" is more frequently referred to as "displacement" a concept that is supposed to combine the ideas of economic shock and innovation. Since "novel offering" is, however, more descriptive of what actually happens in the formation of a bubble, it is often substituted for "displacement" in concrete treatments. See Kindelberger and Aliber, *Manias, Panics, and Crashes*, 47–50.

7. Floyd Norris, "Who's Going to Take the Financial Weight?," *New York Times,* October 26, 2007; "Default Fears Unnerve Markets," *Wall Street Journal*, January 18, 2008.

8. Federal Reserve Bank of New York, "Historical Changes of the Target Federal Funds and Discount Rates," http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html.

9. Landa, "Deconstructing the Credit Bubble."

10. Hyman Minsky, *Can "It" Happen Again?* (New York: M.E. Sharpe, 1982), 28–29.

11. "Household Financial Condition: Q4 2005," Financial Markets Center, March 19, 2006, http://www.fmcenter.org; Foster, "The Household Debt Bubble," 8.

12. "Global Derivatives Market Expands to $516 Trillion (Update)," Bloomberg.com, November 22, 2007.

13. "Bond Insurer Woes May Mean End of Loophole," *Reuters*, February 13, 2008.

14. "Global Recession Risk Grows as U.S. 'Damage' Spreads," Bloomberg.com, January 28, 2008. This report refers to the world recession level, as depicted by economists, as 3 percent or lower. But 2.5 percent is probably more accurate, i.e., more closely in line with recent world recessions and IMF views.

15. Stephen Roach, "America's Inflated Asset Prices Must Fall," *Financial Times,* January 8, 2008.

16. "Decline in Home Prices Accelerates,"

Wall Street Journal, February 27, 2008.
17. Eric Janszen, “The Next Bubble,” *Harper’s* (February 2008), 39–45.
18. Roach, “America’s Inflated Asset Prices Must Fall,” and “You Can Almost Hear it Pop,” *New York Times*, December 16, 2007.

19. Fred Magdoff, “The Explosion of Debt and Speculation,” 9.

20. The term “stagnation thesis” was originally associated primarily with Alvin Hansen’s argument in response to the Great Depression. See Hansen, “The Stagnation Thesis” in American Economic Association, *Readings in Fiscal Policy* (Homewood, Illinois: Richard D. Irwin, Inc., 1955), 540–57. It was later applied to Baran and Sweezy’s *Monopoly Capital*. See Harry Magdoff, “Monopoly Capital” (review), *Economic Development and Cultural Change* 16, no. 1 (October 1967): 148.

21. The concept of the “wealth effect” refers to the tendency for consumption to grow independently of income due to rising asset prices under financialization. The earliest known use of the term was in a January 27, 1975, article in *Business Week* entitled “How Sagging Stocks Depress the Economy.” Alan Greenspan employed the concept of the “wealth effect” in 1980 to refer to the effect of the increase in the price of homes in stimulating consumption by home owners—Greenspan, “The Great Malaise,” *Challenge* 23, no. 1 (March–April 1980): 38. He later used it to rationalize the New Economy stock market bubble of the 1990s.

22. Harry Magdoff and Paul M. Sweezy, “Production and Finance,” *Monthly Review* 35, no. 1 (May 1983): 11–12.

23. The basic argument here was articulated in numerous publications by Paul Baran, Paul Sweezy, and Harry Magdoff in the 1950s through 1990s.

24. Federal Reserve Statistical Release, G.17, “Industrial Production and Capacity Utilization,” February 15, 2008, http://www.federalreserve.gov/releases/g17/Current/default.htm; John Bellamy Foster, “The Limits of U.S. Capitalism: Surplus Capacity and Capacity Surplus,” in Foster and Henryk Szlajfer, ed., *The Faltering Economy* (New York: Monthly Review Press, 1984), 207.

25. Harold G. Vatter, “The Atrophy of Net Investment,” in Vatter and John F. Walker, *The Inevitability of Government Spending* (New York: Columbia University Press, 1990), 7. Vatter notes that that net investment as a share of net national product (NNP) dropped by half between the last quarter of the nineteenth century and the mid-twentieth century, Vatter and Walker, *Inevitability of Government Spending,* 8.

26. “Companies are Piling Up Cash,” *New York Times*, March 4, 2008. This piling up of cash has been the product of the last decade, with the average level of cash as a percent of total assets of corporations in the Standard & Poor’ s 500-stock index doubling between 1998 and 2004 (and the median ratio tripling).

27. Chalmers Johnson, “Why the US has Really Gone Broke,” *Le Monde Diplomatique* (English edition), February 2008. Johnson’s $1 trillion figure for U.S. military spending is arrived at by adding the supplemental requests for the wars in Iraq and Afghanistan to the Department of Defense fiscal year 2008 budget (creating a grand total of $766 billion), and then adding to this the hidden military spending

in the budgets for the Department of Energy, the Department of Homeland Security, Veterans Affairs, etc.

28. Paul M. Sweezy, “Economic Reminiscences,” *Monthly Review* 47, no. 1 (May 1995), 8–9.

29. Thomas I. Palley, “Financialization: What It Is and Why It Matters,” *Working Paper Series*, no. 153, Political Economy Research Institute, November 2007, 1, 3, 8, 11, 21, http://www.peri.umass.edu/Publication.236+M505d3f0bd8c.0.html

30. See Kindelberger and Aliber, *Manias, Panics, and Crashes*, 126–35.

31. Özgür Orhangazi, “Financialization and Capital Accumulation in the Non-Financial Corporate Sector,” *Working Paper Series*, no. 149, Political Economy Research Institute, October 2007, 3–7, 45, http://www.peri.umass.edu/Publication.236+M547c453b405.0.html.

32. Harry Magdoff and Paul M. Sweezy, *The Irreversible Crisis* (New York: Monthly Review Press, 1988), 49.

33. Sweezy, “Economic Reminiscences,” 9–10.