The global financial crisis as a world great depression

An analysis using Marxian economics

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The current global financial crisis constitutes a great depression that is raging on a global scale, which I believe can be best understood in the context of the following scheme.

Since the 1990s, the world economy has been experiencing the phenomena of surplus money and surplus capital. What has emerged from these twin phenomena is a very conspicuous case of the wagging the dog: that is, the financial economy (the tail) is seen to be wagging the real economy (the dog).

Some thought has to be given at this point to the meaning of "surplus". For our purposes, let us adopt the following definitions. First, "surplus funds" refers to funds for which new fields of investment are difficult to find. By implication then, surplus funds are funds for which invest opportunities that would yield a certain expected profit rate cannot be found (Y. Suzuki). On the other hand, "surplus money capital" is generated when the accumulation of money capital proceeds on a global market scale at a pace that exceeds the accumulation of real capital, such that money capital cannot readily be converted into real capital—that is, money capital that cannot participate in generating the expected profit rate (H. Koni). In other words, surplus funds and surplus money capital are not directed toward investments because of the very low expected profit rate. Instead in pursuit of financial gain, surplus funds and surplus money capital remain in the financial market (or, in certain cases, in the commodities market) where they roam about in the form of money. Of course, this does not imply the companies themselves are being transformed into money capitalists. On this particular points, it should be understand that the lion's share of corporate profits are absorbed by the very high levels of executive remuneration, the buyback of the company's own shares, and merger and acquisition (M&A) activities.

In discussing surplus funds and surplus money capital, the following three facts should be pointed out:

1 In the United States, funds raised by corporations in the stock markets have remained negative on a net basis since the 1980s. This is because, while many companies continue to issue new shares, they are constantly outnumbered by companies that are utilizing surplus funds and surplus money capital to buy back and retire their own shares as a defense against M&A threats from other companies. Moreover, consider the case of leveraged buyouts (LBOs), which deem corporations to be no more than a certain types of financial instrument. (In LBOs, the acquiring company procures the necessary funds for acquisition by pledging the assets of the acquired company as collateral. LBOs are frequently aimed at restructuring and reselling the acquired company at higher price.) The proliferation of LBOs bears eloquent testimony to the fact that acquiring companies have determined that the expected profit rate on productive investments in their own business fields is unacceptably low.

2 The fact that profit rates are declining in the industrialized countries can be readily confirmed by observing the trends in the real yield of ten-year government bonds, which serves as a substitute variable for the profit rate (K. Mizuno). Specifically, real yields in the industrialized capitalistic countries fell sharply from an average of 4.8 percent for the 1980s and through the half of the 1990s to the 2-percent range after 2004. Thus, the rate of return on real investments with a ten-year maturity has declined precipitously (ibid.).

3 The approximate scale of global financial assets can be estimated by taking aggregate market capitalization, the outstanding balance of stocks and bonds issued, and aggregate amount of deposits. Comparing the sum of these to nominal GDP for the entire world reveals the fact that, whereas global financial assets amounted to 1.7 times global GDP in 1990, this ratio had risen to 3.2 times by 2006.

It should be noted that this surplus money or surplus capital can take various forms, such as the funds available to institutional investors that comprise pension funds, foundations, insurance companies, and investment trusts. Other prominent forms include hedge funds, sovereign wealth funds, the foreign currency reserves of current-account surplus countries. Funds supplied from these sources are absorbed into a broad range of financial markets. Needless to say, the leading markets for financial investors consist of stock markets, bond markets, interest markets, and foreign exchange markets. Parallel to these markets, funds are also absorbed into derivatives markets that utilize the foregoing financial instruments (stock, bond, interest, foreign exchange) as underlying assets. Furthermore, these funds go to various types of asset-backed securities (ABSs) markets, including residential mortgage-backed securities (RMBS) markets, as well as commodity markets. Finally in this context the credit-creating ability of commercial banks must not be overlooked.

Furthermore, the existence of surplus money or surplus capital can be seen as a representation of the risk of overproduction that lies dormant in the capitalistic economy. That is to say, if this surplus money or surplus capital is directed toward productive investments, the modern capitalistic economy would immediately experience overproduction.

Thus far, we have looked only at the side of nonfinancial corporations. However, significant changes have also taken place on the side of financial institutions. Certainly, we must not overlook the collapse of traditional business models in the financial sector and the ongoing transitions to new models.

To begin with, commercial banks have shifted the focus of their lending from the productive sphere to non-productive, personal, and financial spheres. The latter group includes lending to LBOs (a form of lending that does not lead to an increase in investment or production from perspective of the national economy), hedge funds, and households. As commercial banks continue to shift their focus, their primary source of revenue has also begun to shift from earnings on interest margins to earnings on fee-based business, a part of which originates in the securitization of loans to households and LBOs. Looking at this situation from a different vantage point, one can say that commercial banks have found that they have no alternative but to turn to these types of activities to fill in as their primary revenue source. This must be seen as the collapse of the existing business model, which is based on interest margins derived from lending to productive corporations, and the transition to new models.

We turn next to investment banks. When we exclude revenues derived from proprietary trading, the revenue source of investment banks can be seen to be shifting from fees earned on the underwriting of stocks and corporate bonds to fees earned on M&A advisory services, the securitization of housing loans, and the management of surplus money and surplus capital held by investors. One of the reasons for this shift can be found in the enactment of the Gramm－Leach－Bliley Act of 1999, which abolished Section 20 of the Grass－Steagall Act of 1933 (That banned banks from entering into corporate affiliations with companies principally engaged in securities underwriting). The abolition of Section 20 effectively opened the way for bank holding companies and national banks to enter securities business through the formation of sister companies and subsidiaries. (This, however, does not mean that Gramm－Leach－Bliley Act allowed investment banks to accept deposits.) The crucial point under the new legislation was that investment banks were left with no other way than the above-mentioned activities to earn substantial revenues. With competition from commercial banks, where else could the investment banks turn for revenue? This change must also be seen as a transition to new business models following the collapse of the traditional business model that was based on fees earned on the underwriting of stocks and corporate bonds.

In a well-known passage, Lenin states: "The concentration of production, the monopolies arising therefrom, the merging or concrescence of banks with industry: this is the history of the rise of finance capital and the content of this concept." Furthermore, Hilferding presents the following argument.

> The banks have to invest ever-increasing part of their capital in industry, and in this way they become to a greater and greater extent industrial capitalists. I call bank capital, that is, capital in money form which is actually transformed in this way into industrial capital, finance capital.

The question arises whether "the content" of the concept of finance capital, particularly "the merging or concrescence of banks with industry" and "bank capital, that is, capital in money form which is actually transformed in this way into industrial capital," is consistent with the content of the concept of modern finance capital.

While at this point I have yet to arrive at a final conclusion and definitive expression, in light of the surplus funds and surplus money capital, and in considering the collapse of the traditional business models of commercial banks and investment banks and their pursuit of new models, I believe that labeling modern finance capital as “casino-type finance capital” is certainly a viable option. In view of the fact that the terms “casino-capitalism” and “financial capitalism” are already in common use, it seems to me that casino-type finance capital is an appropriate and defensible expression.

Assuming that the concept of casino-type finance capital can be outlined as above, this presentation of the concept directly and immediately leads us to an awareness of the parasitism and decay that lies within casino-type finance capital. In other words, whereas in the traditional setting, the productive sphere and productive profits functioned as primary source of revenues, casino-type finance capital comprises none other than a form of finance capital with marked tendencies for deriving its revenues from the personal sphere and personal income, and from the financial sphere and financial gain.

When we examine the process of financial deregulation and globalization that has gained momentum since the 1980s, we can say without any doubt that this process was advocated and carried forward by an amalgam of casino-type finance capital and the state, and that casino-type finance capital clearly lies behind the current financial crisis which constitutes a world great depression.

Perhaps a caveat should be interjected at this point: this explanation of casino-type financial capital does not in any way imply that the intimate relationships that exist between industry and financial institutions under modern capitalism have been severed or in any way undermined. This intimate relation continues to exist as can be reaffirmed from the fact that failing major corporations still have nowhere to turn for their final salvation but to banks and to state.

On the other hand, in view of the essential features of the world of finance, the following five points can be readily confined:

1 Insofar as economic bubbles constitute a dramatic rise in asset prices (or commodity prices) to a degree that cannot be validated by developments in the real economy, while it may not be possible to predict the timing and trigger in advance, it can be stated with certainly that all bubbles eventually collapse.

2 From the perspective of the national economy, financial transactions do not generate value or value-added in and of themselves. From the point of view of Marxian economics, interest is nothing more than a special term used to describe the amount that is part of the average profit generated by an industrial capitalist who borrows money (that is, possible or potential money) from money capitalists (or banks) and utilizes the money productively, and that is not pocketed by the industrial capitalist and is instead handed over to money capitalist (or banks). Hence, financial transactions, such as lending and borrowing, do not generate interest as part of any form of created value. The same applies to buying and selling of stocks and land (homes). These transactions also do not generate any value or value-added.

3 While derivatives and the securitization of housing loans and other assets may be used to transfer risk from financial institutions to investors, they do not function as instruments for reducing or eliminating overall risk. In other words derivatives and the securitization cannot rise above strictures of a zero-sum game.

4 Financial institutions (commercial banks and investment banks) derive revenue from the securitization of housing loans in the form of fees, such as securitization fees and selling fees. Financial institutions also gain from the spread between the lending or purchase price of housing loans and the selling price of mortgage-backed securities made up of these housing loans. Finally, investors earn interest income on the financial instruments they hold. However, all of the above revenue streams originate in and are bounded by the interest paid by households that have taken out housing loans.

5 In other words, from the point of view of Marxian economics, the world of finance provides nothing more than a framework for redistributing existing value or value-added.

Let us now attempt to tie together the essence of casino-type financial capital with the essence of the world of finance. It will be interesting to see what understanding can be gleaned and what conclusion can be derived from this juxtaposition. The answer is immediately obvious. Casino-type financial capital periodically gives rise to economic bubbles (which frequently result in the revitalization of the real economy). After an economic bubble has formed, institutional investors (primarily consisting of pension funds, investment trusts, and hedge funds) heavily laden with surplus funds and surplus money capital that cannot find their way to productive investment are inexorably sucked into the vortex of the bubble. It is only by doing so and by fully and aggressively utilizing its credit creating ability (the ability unique to commercial banks and not shared by investment banks) that casino-type finance capital can achieve the expected level of financial gain.

This conception allows us to gain a very clear and full understanding of a series of economic events that have occurred since the 1990s, including the Asian and Russian currency crisis, the rise and fall of the dot-com bubble, the rise and fall of the housing bubble, and the rise and fall of the oil and grains.

This brings us to the next set of question. Compared to these earlier financial crises, why has the current financial crisis become so severe? Why didn't this crisis remain localized in the United States? And finally, how did this crisis develop into a global financial crisis and further morph into a great depression on a world scale?

Let us begin with a closer look at the aspect of global financial crisis. It is immediately obvious that a number of developments stand at the root of this phenomenon of global financial crisis. It cannot be denied that the most notable contributing factors include problems arising from the proliferation of derivatives and the securitization of housing loans and various other loans. In turn, these developments are closely linked to financial globalization and advances in financial engineering. In the process, a host of previously unknown terms have come to be widely used in both the business world and in academia, such as collateralized debt obligations (CDOs), CDOs squared, credit default swaps (CDSs), and synthetic CDOs. In the final analysis, the essence of what occurred can be summarized as follows. First, historically low interest rates on a global scene fed the financial bubble. Next, U.S. commercial banks and investment banks originated various relatively high-yield ABSs and CDOs products that provided an ideal destination for surplus funds and surplus money capital. Sure enough, not only U.S. investors but also inventors from throughout the world, including European and Japanese financial institutions, vied to purchase these financial instruments. As the final piece of the scheme, CDSs were brought in to hedge the risks of the huge volume of ABSs and CDOs that has been acquired.

The current global financial crisis is rooted in the confluence of a number of conditions that include the accumulation of surplus funds and surplus money capital, the emergence of casino-type finance capital, financial globalization, and the widespread use of derivatives and securitization. If these conditions had not existed together, the current financial crisis would most probably have remained localized in the United States and would not have developed into global financial crisis. However this observation does not imply that the modern capitalistic economy has the option of turning back from where it stands today. This inability to turn back in fact symbolizes the dilemma that is inherent in the modern capitalistic economy.

Next, let us consider the aspect of a world depression. As we observe economic bubbles, on the one hand, we can clearly determine that bubbles have a far-reaching impact on the real economy. In the case of housing bubble, the extension of housing loans by commercial banks combined with sharp rise in property values stimulates personal consumption, which in turn activates the real economy by increasing the corporate sector's plant and equipment investment. By the same token, the collapse of an economic bubble extracts a heavy toll on the real economy. Once again in the case of a housing bubble, the process begins to unwind with rapidly declining property prices. Parallel to this, commercial banks begin to accumulate bad loans and experience serious deterioration of capital to risk-weighted assets ratio, the outcome of which is precipitous cutback in lending to households and firms. These factors combine to suppress personal consumption and plant and equipment investment, which ultimately result in the slowdown and stagnation of the real economy. The conclusion and lesson derived from the observation of economic bubbles is that both of these opposing developments must be kept in mind simultaneously. The implication that financial economy, as the tail, is wagging the real economy, as the dog, must be examined in this context.

This can be restated as follows. Looking at the domestic U.S. economy, the housing bubble led to overconsumption (consumption exceeding the repayment ability of home loan borrowers) as well as overinvestment (investment instigated by overconsumption). These developments resulted in an increase in U.S. imports and increase in exports of other countries to the United States. Exports to the United States from China and other Asian countries and European nations increased. While Japanese exports to the

United States decreased, Japanese exports to China increased. Consequently, the United States came to play the role of locomotive to the world economy and ultimately served to stimulate and activate the entire world economy. However the reverse side of overconsumption and overinvestment was overproduction, an outcome that obviously could not avoided. The collapse of the housing bubble triggered the reverse of this process. Under the newly emergent circumstances, the overproduction that had remained dormant until then would sooner or later manifest itself, giving birth to depression.

The situation would soon be further worsened by the vicious cycle that was set in motion by the deterioration of the financial economy and the downturn in real economy.

Looking back to the Asian and Russian currency crisis, dot-com bubble, and the speculative boom in oil and grains, it is notable that the scope of each of these past crises was localized and remained within the geographic or market confines of Asia and Russia, the United States, and the commodity markets, respectively. On the other hand, the recent housing bubble has had a global impact, both in terms of the financial economy and the real economy. Herein lies the most salient feature of the current economic crisis, which rendered its development into a financial crisis and world great depression inevitable.

Finally a comment is in order regarding the future outlook. Let us suppose that governments and central banks temporarily succeed in bringing the current crisis and depression under control and ending them by resorting to the maximum available measures of fiscal and monetary policies. The crux of the problem is that such a solution does not by any means imply an elimination of surplus money or surplus capital. The irony of the situation is that surplus money and surplus capital are supported and bolstered by the very fiscal and monetary measures to overcome the crisis and depression, and for the most part will continue to exist, including the credit-creating ability of commercial banks. From there, surplus money and surplus capital will continue to roam freely in the financial markets (and commodities markets). That will, as a matter of course, lead to a situation in which casino-type finance capital will continue to dominate the modern capitalistic economy, conspiring to use surplus money and surplus capital in another round of moneymaking. There is no way to predict the scale and form of the next bubble because much will depend on the positions taken in fiscal regulation and supervision, which in turn will be affected to the great extent by the casino-type finance capital lobby. However, what can be predicted with confidence is that other bubbles will inevitably continue to form and to collapse in the future.