Magdoff-Sweezy and Minsky on the Real Subsumption of Labour to Finance

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1. Monopoly capital and stagnation: the condition for the new forms of financial growth: Magdoff-Sweezy and Minsky

In the late 1970s a slim book was published containing the essays by Harry Magdoff and Paul Sweezy (1977) in *Monthly Review*. In it the authors argued that US capitalism was characterized by stagnation and indebtedness, the latter overwhelmingly on the private side. The central issue they raised was that banks where skating on thin ice. For Magdoff and Sweezy there was a connection running from monopoly capitalism to indebtedness. In a nutshell, the regime of oligopolistic capitalism generates a built in tendency towards unused capacity. The ensuing deficiency in effective demand relatively to the productive potential compels the private sector to rely on a growing debt. The central piece of that collection was a quite technical paper on the economics of banking which, with the benefit of the knowledge of what happened since those years, appears as remarkably far-sighted ("Banks: skating on thin ice", in Magdoff and Sweezy, 1977).

The essay showed how the expansion of lending was not the result of optimistic buoyancy regarding the economy, because growth rates had faltered. Rather, increased lending became the instrument to make money by gambling on the future capacity of the loans to be repaid despite liquidity constraints and the fact that the time needed for implementing business investment in capital equipment, and for the returns to flow in, was longer than the repayment of loans. Magdoff and Sweezy identified a shift towards greater short term borrowing. Shortly afterwards they pointed out to another phenomenon coming on top of that just mentioned, namely the systemic increase in the ratio of consumers' debt to disposable income. Both phenomena, they argued, stemmed from the underlying stagnationist tendency

requiring an ever increasing indebtedness to keep the economy going (Magdoff and Sweezy, 1981).

There is today a world wide revival of Hyman Minsky's views about financial instability, which may be connected to the Magdoff-Sweezy approach. In Minsky's case the burgeoning of credit happens when times are good and banks issue ever growing loans. A point is reached however where this process is not sustainable. Borrowers cannot meet interest payments, inducing a systemic tendency to a financial decelerator and debt deflation. Loans for which payments are due are called back and the whole system slides towards a credit crunch which then becomes a financial crisis with real repercussions on the level of effective demand and employment. In the Magdoff and Sweezy approach we must distinguish between the different periods in the history of US capitalism. The dynamics of the overextension of credit must be put in the specific context in which the economy operates.

A systemic tendency to stagnation has been a structural feature of the American economy since the Great Depression, but it has always been countered by political countertendencies and original economic policies, often making the system very dynamic. In the *Journal of Post Keynesian Economics* Walker and Vatter (1986) have shown that from 1933 to 1983, excluding the WW2 years, the US economy functioned at its potential or above it for a total of only 10 years. Of these 3 were during the Korean War and 5 during the Vietnam War. At the same time, in the half a century considered a sharp change in the crisis process took place. Before WW2 the system was prone to catastrophic collapses. Instead, after 1945 stagnation had been counteracted by institutional means such as military spending. This was not true only in relation to the United States. Charles Kindleberger stated in *Power and Money* (1970) that for Europe the Marshall Plan never ended as it just metamorphosed into the NATO military alliance, much of which financed by Washington.

Yet, Magdoff and Sweezy went on to highlight another force which since the time of their writing became the main factor sustaining accumulation:

> Among the forces counteracting the tendency to stagnation, none has been more important or less understood by economic analysts than the growth, beginning in the 1960s and rapidly gaining momentum after the severe recession of the 1970s, of the country debt structure (government, corporate, and individual) at a pace far exceeding the sluggish expansion of the 'real' economy. The result has been the emergence of an unprecedentedly huge and fragile financial superstructure subject to stresses and strains that increasingly threaten the economy as a whole (Magdoff and Sweezy, 1987, p.13).

The growth of debt in the 1960s is consistent with Minsky's views about banks' eagerness to lend in boom times; the subsequent expansion of lending too. The long boom was followed by the stagnation of the 1970s, but, as Minsky said, this is what should be expected when 'Keynesian' economic policies intervene with the Big Bank and the Big Government: the price is that the extension of debt goes together with a slow down of growth and an increase in prices and wages. This also explain why the increase in debt in the 1960s, especially for households and corporations of all kinds, was much less than during the low growth decade of the 1970s. As Minsky and Magdoff-Sweezy would have expected, the financial system could not become more

conservative, unless risking another Great Crash like in the 1930s. Moreover, with the negative real interest rates for the 1973-78 period there was an incentive to borrow as much as to lend, since the real sector was likely to generate returns higher than the interest rates.

The 1980s signal however the beginning of a turning point, so that the debt dynamics of the following decades cannot be fully explained with Minsky and/or Magdoff-Sweezy. They were years of rather volatile and abrupt growth rates as exemplified by the sharp V shaped recession of 1981-82, coupled with high interest rates and inflation. On the whole the US real growth rate in the 1980s rose only marginally above that of the previous decade. Why then financial institutions launched into an unprecedented lending spree? The Magdoff-Sweezy and the Minsky dynamics which link the rise of debt and of the financial 'innovation' witnessed after the 1980s, to the deficiency of profitable effective demand appears convincing as the starting conceptual framework for understanding the process that has led to the collapse of 2007-8, but they must be developed and integrated. Only two elements of a new shape of capitalism can be underlined here: the role of capital market inflation; and the construction of a perverse connection between the 'traumatized' workers, on one side, and the 'manic-depressive' savers plus indebted consumers, on the other.

2. Capital market inflation: Toporowski

The first is the capital assets inflation on which Toporowski (2000) has, rightly, insisted so much in many of his works. Contrary to Minsky's expectations, the indebtedness has been especially significant for financial businesses, and lately for households, rather than non-financial firms. Securities issued by financial intermediaries and bought by other financial intermediaries exploded. This does not represent a net expansion of credit. The building up of the capitalism of pension and institutional funds (beginning with US and UK), and which corresponds to what Minsky would call money manager capitalism, had a direct impact on the balance sheet of corporations especially since the 1980s, with corporations issuing securities in the capital markets finding that they could issue shares cheaply. The return on shares was mainly in the form of capital gains, and this was a crucial factor in originating a systematic and disequilibrating capital assets inflation. Corporations issued capital in excess of their commercial and industrial needs.

A loop between financial inflation and overcapitalisation became embedded in the system, facilitated by the mere interest of fund managers in financial returns and shareholder value, and also by new techniques of senior management remuneration and of debt management. Bank borrowing was substituted by cheaper long term capital and excess capital. This latter was also reinvested in buying short-term financial assets. The merger and takeover mania, and the balance sheet restructuring, was part of the story Toporowski tells. A story which also enlightens why banks were forced to change their nature into fee-related businesses or originate-and-distribute activities, losing large corporations as costumers and then becoming more and more fragile.

As again Toporowski teaches us, capital market inflation fuelled both the long equity financing boom and the housing market boom. Markets where the prospects of capital gains made disequilibrium feeding up on itself, increased for a long while liquidity,

and improved the quality of collateral - Minsky's margin of safety became endogenously better and better in a self-justifying process. The rise in asset values had no roof because there was no automatic readjustment mechanism, no in-built tendency to equilibrium (of which both Neo-Classicals and Neo-Ricardians are so fond).

The most interesting points for the rest of our story are however the effects on the non financial companies' debt and on household debt. The former (the non financial companies debt), as we already hinted, was reduced. The 'industrial capital' sector became more stable: something which went against the Minsky orthodoxy, but which was also not adequately appreciated by the Baran--Magdoff-Sweezy tradition. The latter (the household debt) not only was increased, but supported consumption against stagnating if not declining individual personal incomes for most of wage earners. The collapse of the saving propensity to consume relative to personal income increased the multiplier and again stabilized the financial position of firms.

As Toporowski puts it, this mutually reinforcing combination of capital assets inflation and collateralised lending, hedged speculative and Ponzi financing structures through capital gains, delaying the onset of the crisis. As long as asset inflation continued, asset markets remained liquid and made possible the building up of collateralised debt. Thus, it was not investments which caused over-indebtedness for non-financial companies. Rather, debt was 'forced' into them. Initially, because of the capital asset inflation process on the rise, and because of the behaviour of financial intermediaries. Later, for the downside effects on the same non financial companies's cash inflows resulting from the breakdown in capital asset inflation.

3. The prices of capital assets

Before turning to the second aspect we wish to insist upon, let us return to Minsky's approach. It has a conceptual segment that, once suitably modified, may help explaining the profit dynamics of a stagnation driven system. In Minsky's system there are two set of prices. The first set of prices is that of current production and, in most cases, prices are set by standard mark-up procedures. The second set of prices is that of capital assets. Here it may be useful to refer to Keynes.

In Chapter 16 of the *General Theory* Keynes wrote:

> It is much preferable to speak of capital as having a yield over the course of its life in excess of its original cost, than as being *productive.* For the only reason why an asset offers a prospect of yielding during its life services having an aggregate value greater than its initial supply price is because it is *scarce;* and it is kept scarce because of the competition of the rate of interest on money. If capital becomes less scarce, the excess yield will diminish, without its having become less productive — at least in the physical sense (Keynes, 1936, p. 213).

For Keynes, and this is the thrust of chapter 16, it is the financial system which allows capital assets to generate rent like returns. The scarcity of capital assets is clearly a social one but its social formation is not explained in Keynes. Minsky goes farther arguing that the demand price of capital assets is largely disconnected from the costs of production. This second capital asset price is separate from the cost of production prices because it depends upon expectations and, according to Minsky, is

tied to the values of stocks. The dependency upon expectations of the demand price for capital assets makes it volatile for the reasons outlined by Keynes in Chapter 12 of the *General Theory* which deals with the uncertain nature of long term expectations.

The relation between the price of capital assets and the price of current production is, for Minsky, the pivotal relative price under capitalism. Favorable investment conditions rule whenever the former price rises relatively to the latter. The demand price for capital assets arises from within the sphere of finance, whereas the supply price of capital goods is determined within the sphere of production. In this context the intersection of the rising supply curve for capital goods with the demand curve for capital assets determines the level of investment and its dynamics. By adding up all the firms Minsky obtains the aggregate level of investment, and then a tendency to an increasing leverage.

We shall not delve into the issue whether this micro-foundation of Minsky's Financial Instability Hypothesis is sound or not. We just warn that in reality both Keynes' story concerning the socially constructed scarcity of capital assets, as well as Minsky's two price system pertain not to supply and demand relations but to the realm of capital as a social relation. This central aspect of the analysis of capitalism is regularly eluded by Post Keynesians, since they invariably veer off towards policy counseling which cannot possibly delve into the question of capital as a social relation as it must take the basic institutional framework as given, as a natural aspect of our existence. And this central aspect, which was the distinguishing feature of Marx from the Classics, will loom large in the remainder of this paper.

4. From the tendency towards stagnation to the 'new capitalism' : the longer view

To understand better the situation we are in, we ought to view it in a longer run perspective. The crisis is not the outcome of reckless neoliberalism, as often is wrongly claimed. Many things have happened in the last four decades since the neoliberal turn of 1979-80, except the retreat of the State in a general sense. Certainly the U-turn of the 1979-1980 was accompanied by a drastic increase in interest rates, nominal and real, by the spread of uncertainty and the ensuing fall in investment. Social public expenditure was curtailed and wages as a proportion of national income also fell reducing wage earners' consumption. Then, one is entitled to ask, why hasn't the Great Effective Demand crisis materialized already in the 1980s?

The quick answer is that there were political countertendencies. The most visible has been Reagan's twin deficits which kept the US economy above water and, by implication through increased US imports, that of the rest of the industrialized world and of Asia. The United States, along with other much smaller countries such as the United Kingdom, Spain, Australia, acted as the market outlet of last resort both for the strong neomercantilisms of Germany and Japan and for the weak ones like Italy's.

But these were just countertendencies. The crux of the matter is that, as a direct consequence of the neoliberal U-turn, during the 1990s has emerged a new form of capitalism. To be clear we do not think that this 'new' capitalism is the so-called 'globalization' of the world in a proper sense, nor is it the alleged Empire dreamed by Negri, and, finally it is most definitely not the supposedly knowledge centered

capitalism based on immaterial production and crisis free. The novelties, though, were significant and we would be powerless if we fail to grasp them. This 'new capitalism', which relatively to the 20th century one resurrects some aspects prevailing in the 19th century, is characterized by the three interconnected figures we already named: the traumatized workers, the manic-depressive savers, the indebted consumers. Its functioning is entirely based on the link between financialization and the casualisation of working and employment conditions. It is to this second element of the new shape of capitalism which we now turn: an element which interacts with the first stressed by Toporowski.

5. Financial capitalism, traumatized workers, centralization without concentration

The first figure, namely, that of the traumatized workers - the label is not ours: it is Greenspan's - is itself the product of the renewed supremacy of finance which had a real effect on the organization of production. This is shown by the impact on employment and employment contracts of junk bonds trading, of equity investment takeovers and the like. The renewed supremacy of finance is not external to the system of productive and industrial firms. Paul Sweezy, back in early 1970s, observed that the main focus of the large corporation is financial. The same truth can be derived from Minsky. Money manager capitalism emanates from within the so-called industrial units of monopoly capital. From corporate executives interested in the financial side of the corporation's activities, rather than the productive and engineering side, to the rise of money managers that, from within finance companies, try to maximize short term returns, the step is very short indeed. What is required is the extension to the whole economic system of the view that what matters is the short term monetary outcome. If real investment and accumulation lag and stagnate the consensus among the ruling groups on short term financial gains, can be reached quickly.

Specialized financial companies in portfolio management spring up from banks and/or other financial institutions. Portfolio managers balance the stakes they have in many different companies, being unable therefore to strictly study the specificity of each of them. Furthermore the design of financial instruments to disperse risk leads to a portfolio in which those instruments engulf several companies at once so that they are not known to the so-called money managers. The objective of the latter reduces to seeking the highest possible financial returns in the very short period. The short term horizon of financial management has been institutionalized by legislation which compels quarterly reporting on mark-to-market criteria. Only in early 2009, with the deepening financial crisis has the United States reverted to annual reporting abandoning the mark-to-market method. In seeking those short term returns money managers, who have vested interests in the short term approach through stock options remunerations, exercise a significant influence over the organization of production and of work.

As a consequence we have witnessed a process of centralization without concentration, hand in hand with aggressive competition among capitals leading to systemic oversupply; the latter being a precondition for overproduction. Key sectors have gone through massive processes of acquisitions and mergers which required the

mobilization of money well above the needs of selffinancing. Yet rather than large vertically integrated companies the outcome has been that of a productive structure oriented towards a network of plants and of productive units interacting through value chain networks. In other words, the centralization of capital through mergers was not accompanied by its productive concentration. This means that that there is a hierarchy of firms within the network system and the conditions of the employees depend upon the position of each firm in the value chain hierarchy. The tendency of centralization without concentration helps to explain why the growth in production no longer entails the expansion of a homogeneous working class in a homogeneous territory (Sheffield till the late 1960s, Lille till the late 1970s, Milan till the late 1980s, etc) sharing the same material and juridical/legal conditions. The labor process is now fragmented and the degree of job casualisation may be limited in one pole and of devastating intensity in another, acting as threat on the more stable one. These outcomes have been brought about by the unleashing of capitalism, to use the effective title of the last book by the late Andrew Glyn (2006). It is worth while to outline the process before we move to the analysis of the subsumption of labor under finance proper.

6. The historical process leading to the subsumption of labor

The subsumption of labor by finance occurred in connection with the belief that the economic environment would stay relatively calm thanks to the means used to stave off stagnation. Since the European countries accepted and even nurtured stagnation in order to enforce wage deflation, the measures to fight stagnation came mostly from the United States and Japan. These are both the two largest economies in the world and the most interconnected. For reasons going back to the reconstruction of Japan's capitalism, supported by the United States after 1945, Japan is hooked onto the USA. In 1987 with the October 9 Wall Street crash, Japan very quickly reflated its economy by sharply reducing the interest rate charged by the Central Bank, thereby flooding with money both itself and the American financial markets. That move turned out to be crucial to refuel the liquidity starved US stock exchange system but it also created a speculative bubble of gigantic proportions in Japan. The bubble was pricked by Tokyo's government in 1992 (through an increase in interest rates) which feared a clash between the speculative overheating of the economy and its exports dynamics. But in capitalist systems economic policies seldom achieve their stated objectives. Soon the economy collapsed into a state of deep stagnation with the yen rising till 1995. To avoid a true depression, the Japanese government reduced interest rates to about zero and pumped a large amount of money expanding the budget deficit to nearly 10% of GDP.

These hyper Keynesian policies, while preventing Japan from sinking into a depression, did not restart growth. Instead they opened up the way to the so called yen carry trade. It became quite logical for both Japanese and foreign banks and financial companies to borrow in Japan in yens at insignificant interest rates, and "invest" the money in higher yielding securities and stocks in the USA. The Japanese crisis on one hand, and the US response to its own stagnation tendency on the other, became mutually compatible through the carry trade in yen.

In the United States the solution to the stagnation tendency was found in the twin process of indebtedness and financialization. The latter became the main factor directing investment in real plant and equipment. Indeed throughout the 1980s and the

1990s, aside from the military industrial sector, the productive branches servicing the financial sectors grew most and absorbed an increasing share of real investment. Present day financial processes and mechanisms stem from indebtedness which gathered momentum since the late 1970s. Initially it was made mostly by company debts, while becoming in the course of time increasingly determined by households' debt (Magdoff and Sweezy, 1987; Chesnais 2004). Terms like "securitization", describing offerings of titles to sustain private debt, or hedge funds, companies specializing in risk management, appear in the United States with increasing frequency from the late 1970s onward. In that decade US capitalism was caught in a very serious stagnationist crisis determined by the (a) the end of the Vietnam War, (b) the Start agreements with the USSR which capped the level of nuclear arsenals and of their vectors, (c) the ousting of the Shah in Iran which dented another major source of military procurements and directly affected the US oil-finance network (Ferguson and Rogers, 1986). For debt creation to become the offsetting factor of the stagnationist deadlock, institutional space had to be created in the first place.

To put the matter into its historical perspective we must mention that both in the second half of the 1950s and throughout the 1960s heavy fluctuations in the stock exchange affected neither policy decisions nor evaluations regarding future real investment. The Dow Jones index, for instance, was 700 in 1963 and just 750 in 1969 but with intermediate peaks around 1000 points, i.e. it displayed a volatility nearing 50%. Yet these fluctuations were within a closed circuit, as it were, since the banking system was insulated from the stock market because of the legislation passed during the Roosevelt era. The real economy and the profitability of both industry and finance were, instead, propelled by the spending policies induced by the Vietnam War. With the onset of stagnation in the 1970s the political and economic response gravitated towards the transformation of debt into a source of financial rents and of support to effective demand through household indebtedness. In this context, throughout the 1980s and 1990s the required institutional space was created by abolishing the safeguard provisions of the Roosevelt era and by changing pensions' financial flows from funds tied to specific entitlements into funds available for financial markets in which benefits came to depend upon market capitalization.

The institutional expansion of the space for debt creation transformed the preoccupation with stagnation into a belief that financial markets would show a systemic tendency validating expectations concerning future capitalization. But this 'confidence' was essentially the by-product of governmental activities centered on injecting liquidity internationally. Such policies began with the Wall Street crash of 1987, were expanded during the 1990s, and acquired unprecedented proportions with the war in Afghanistan and in Iraq after 2001 and 2003. It is this kind of public money that sustained the fireworks of private moneys and the growth of the derivative markets. Without government created liquidity, the implementation of the large private financial operations of the last decade – from investments into junk bonds to private equity take-overs – would have been much more problematical, if at all possible.

This Ocean of State injected liquidity has had a twofold effect. On one hand it has increased speculation and the volatility that goes with it. On the other hand, however, it seemed to have augmented the capacity to absorb the said volatility. Hence, we witnessed the ingrained belief in the sustainability of an ever growing financialization

of the economy. Although there have been instances of financial bankruptcies with many victims, no chain event had occurred up to 2007 on a scale to shatter the above mentioned belief. That was mostly due to the continuing issuance of liquidity by the public authorities. The explosion of the dotcom bubble in 2000 began to shatter that credence but the swift transformation of American monetary policies into a new form of war financing in 2001 (De Cecco, 2007), created the conditions for the absorption of the many bankruptcies leading to the impression that the financial Ocean would remain essentially calm.

7. The subsumption of labor by finance and monetary policies

By the mid 1990s capitalism had become ripe for a different management of economic policies which were to be accompanied by a new dynamics of capital accumulation. This 'new' capitalism was anything but stagnationist, nor did it eschew, despite the declared deregulation of markets, an eminently political management of effective demand. In the new mode of regulation labor, that is wages, is no longer the source of inflation (this is another difference with the world Minsky had in mind when elaborating on his Financial Instability Hypothesis in the 1970s). Statistically recorded unemployment can be reduced without a rise in wages, which in the United States have been displaying a long term decline, while in Eurozone they are subjected to competitive deflation. The Phillips curve, over which both Keynesians and Monetarists fought throughout the 1970s and part of the 1980s, is now tendentially flat. Indebted consumers are compelled to work more and more intensively thereby unifying an increase in the productive power of labor with longer working hours (in Marxian terminology one would say that the processes of extraction of relative and absolute surplus value were joined together).

The emergence of traumatized workers and indebted consumers has generated a real subsumption of labor by finance which transforms the conditions pertaining to the valorization of production. Capitalism could now head anew towards full employment, which in reality meant the 'full underemployment' of a precariously employed flexible workforce. A full underemployment that could turn rapidly into mass unemployment of the kind we are witnessing to day.

The new capitalist regulation of the 1990s was predicated upon the Central Bank issuing money and liquidity in amounts large enough to inflate stocks which become the preferred destination of private savings, at the detriment of government bonds. Traditional monetarism, based on the control of the supply of money, or on the wish to control that supply, is ditched in favor of the control of the rate of interest with reference to the so-called Taylor rule. The money supply curve too becomes flat: at the rate of interest set by the monetary authorities, the supply of money expands automatically by endogenously responding to demand. What matters in this context is the political management of the rate of interest.

8. Indebted consumers and manic-depressive savers

How did this system of regulation guarantee the dynamics of the system, albeit in a marked uneven context? It is here that the two other characters appear on the stage: the saver in her/his manic-depressive state, and the indebted consumer. They appear when asset price inflation becomes a full blown speculative bubble, making greater

consumption possible by means of additional credit. Savings out of disposable income fall and even become negative. Consumption is, therefore, rendered autonomous from income; it is swelled by the wealth effect induced by the rise of stock or real estate prices.

The figure of the indebted consumer does not correspond to a situation of well being, although it embodies a distortion towards opulent consumption skewed towards non essential items. Yet this is more what appears through the media and the like. As the United States case shows, in order to keep the same average living standards middle class households had to increasingly depend on the work of two people at least. Elizabeth Warren, professor of law at Harvard, has produced a definitive congressional testimony to that effect. She pointed out that US households have been spending a declining share of their incomes on consumption goods, thanks in great part to the 'China price'. The rising part went to medical, education and insurance expenses. These are all sectors with strong financial rent seeking elements. For many households indebtedness has become a necessity and, at least, the only way to maintain an adequate standard of living in the face of falling real weekly earnings (Warren, 2007).

Thus the mechanism centered on the nexus between asset price inflation and monetary policies guaranteed for a relative long phase the monetary realization of surplus value. However, it also doped the system. The indebted consumer has been the main factor pulling the growth rate in the United States, while the latter has acted as the buyer of last resort for the neomercantilist economies of Japan, Korea, partly of Germany, and in a big way of China. The model was however unsustainable as it set in motion a string of speculative bubbles leading to systemic crisis.

9. From bubbles to systemic crisis

The debt driven mechanism, which was in fact an international process although its epicenter was in the USA, plunged into its first major crisis in 2000 with the explosion of the dotcom bubble. Before crises were either shifted onto the periphery (East Asia, Brazil, Russia), and/or limited to specific companies (Long Term Capital). With the end of the dotcom bubble there arose the possibility that the other character in the play, the saver, will plunge into a depressive state. Namely, households, in the face of the fall in their asset values, would be compelled to cut debt thereby reducing expenditure relatively to disposable income.

After 2000 all stops were pulled in order to stave off the crisis and the strategy succeeded by combining a renewed Baran-Magdoff-Sweezy military Keynesianism with flooding the economy with liquidity in the wake of Greenspan's low rate of interest policy. Asia's, and in particular China's and Japan's dependency upon the US market helps. Asian countries have little alternative to refinance US deficits by exporting capital to the Unites States, enabling, in this way, the Federal Reserve to pursue a low interest rate policy. The 'policy' mix, if we can call policy also the ignition of two wars, has caused, hey presto, another round in the real estate price inflation which reproduced in a modified way the bubble mechanism of the *new economy*. More than the latter, which was based on large doses of venture capital, housing price inflation feeds directly into household's debt, via mortgages and via the collateral value represented by real estate. Thus, while the dotcom bubble did require

real investment in plant and equipment, the housing price inflation did not, so that, after 2003, investment lagged behind consumption.

The new bubble however, appeared wobbly from the start as it revealed itself very sensitive to a rise in interest rates. It is for this reason that in the United States it began to sputter in 2004, and by 2005 the decline in house prices commenced. The fragility of the new bubble meant that the Federal Reserve was losing control over monetary policies. In particular, the criterion of setting an inflation target became meaningless. The control of inflation became the instrument to enhance financial asset values. In so far as these stimulated a consumption led growth they tended to rekindle inflation. However, whatever inflationary pressures existed came not from wages but from raw materials or from any possible degree of monopoly that business could firm up. Wage deflation was also made to counterbalance those inflationary spurts. But if inflation were to be held in check far in advance of its actual appearance, interest rates would have to rise. Yet such a move was destabilizing the process of asset price inflation, which the Fed was supposed to support.

It is in that context that a flight of fancy engulfed both government and private business. It was believed that financial market efficiency would perform two connected miracles. The first miracle concerned securitization's power to disperse risk. It was thought also that the effectiveness would be enhanced by increasing the complexity of financial instruments which would allow to set up a labyrinth of combined packages and sale sequences. That it would not be so was understood quite early in the piece. But any warning to that effect was muzzled by government authorities. Indeed, as reported by a reader to the *New York Times* on November 17 2008, in the late 1990s «Brooksley Born, head of the Commodity Futures Trading Commission, proposed greater transparency in derivatives trading involving disclosure of trades and reserves available in case of losses. Summers called Born into his office to chastise her for such a proposal. Eventually her reforms were killed through the efforts of Summers, Robert Rubin, and Alan Greenspan».

The second miracle involved the magic of those phony products to direct surplus savings to the countries which were dissaving, first and foremost to the USA. It did not happen because it could not happen. Securitization is an opaque money making way to unload risk ad infinitum, whereas international imbalances cannot be corrected by the smooth transfers of savings, but rather by generating the real effective demand needed to correct them.

10. The other coin of the crisis: its links to world's neomercantilisms

US debt financed growth tied in with the European and Japanese stagnation as much as with China's export led growth. As the subrpime crisis made itself felt on the financial markets another fanciful theory was dished out to assuage fears regarding the impeding crisis: both China and Europe could decouple from the United States. These views were dished out by respectable news papers like the *Financial Times*, econometrically and strategically endowed think tanks, while any sensible person who just followed the radio news about trade and finance knew that the decoupling thesis was wrong. Needless to say it was the layperson to be on target. There is however an intellectual cum moral aspect to the decoupling story. They were propounded by the very same people, media outlets, think tanks, that for decades argued about the

inevitability of globalization and about its positive role. Globalization as the only game in town was proclaimed also by many battered down leftwing ‘intellectuals’. Now all of a sudden, decoupling was back in vogue, but only for few months. The reality check came and leaving the globalizers mute. Let us focus on Europe where neomercantilism operates in a most perverse form. After all the Japanese and Chinese cases are straightforward: the United States close the effective demand loop of both. Not so in Europe. Let us see why.

The political economy of the European Union has evolved on the same premises and principles of the Common Market (1957) and of the EEC which to day are not valid any more. These are nothing but the objectives of achieving net export balances. Not that every country is in a position to attain that goal. Some countries, like Spain, the United Kingdom, Portugal, Greece and most of the Eastern European members do not even have it as an objective. Britain’s, Spain’s, Greece’s external current accounts have been negative for decades. While Poland, Hungary, and the Baltic States, have combined negative current accounts with large financial sector’s external borrowing, Iceland type, much beyond the need to finance the current account deficits. But the core six countries of the former Common Market with Austria and the three EU’s Scandinavian countries do see export growth as being more significant than the expansion of domestic demand.

Within the export oriented countries there is a definite hierarchy among the big three who happen to be also in the Eurozone. The first in the hierarchy is Germany whose export dynamics did not and does not depend on nominal exchange rates with the other main currencies. Rather, German exports are tied to technological innovations and to the widespread array of capital goods sectors. The price competitiveness element comes from what, for all practical purposes, is wage deflation. Indeed Germany extended that policy to the whole of the Eurozone upon the formation of the euro[1].

The second in line is Italy because her export orientation is exactly the opposite of Germany’s. It was based on a weak currency, on competitive devaluations. But with the Euro the weak currency approach has vanished and Italy needs wage deflation even more than Germany. Third in line is France. Paradoxically France has a net export objective but only occasionally achieves it. Yet the policy posture of France is to combine financial conservatism with wage deflation and neomercantilist goals, though the latter are seldom attained. Thus, as much as the ECB organizes the monetary framework for price stability, wage deflation is, in a manner connected to the national validation of price stability policies set by the ECB, the unifying element in the respective neomercantilist goals.

Neomercantilism to where? The extra European Union’s trade absorbs a substantial part of total EU exports. But the bulk of the surpluses of net exporters are realized

[1] Germany's wage deflation pressure worked also in the 1980s, whereas Italy's competitive devaluation could not work in that decade as it did in the 1970s because of the different dynamics of dollar and mark. Thus between 1980 and 1986 we had Italian competitive devaluations, but they were always running behind the need of firms to gain profitability (as it was during the 1970s , when lira devaluated against the mark following the dollar). Between the 1987 and 1992 we had Italy coupling a strong lira with a deteriorating current account balance. The euro "blocked" all this without any possibility of escape, thereby institutionalizing the wage deflation for every country of the eurozone.

within the EU itself. The other component comes mostly from net exports to the United States. However exports to the USA are around 8% of the European Union's total inclusive of intra- EU trade. For Germany the share of her exports to Eastern Europe is of the same size as exports to the United States. In relation to China, Japan and Korea the EU countries have a growing deficit, determined by the trade with China. Yet in this case we have significant differences. We may distinguish between active and passive deficits. Germany, the Netherlands, and Scandinavia, belong to the former group. France, Italy and Spain are the most significant representatives of the latter. The United Kingdom is a separate case.

Active deficits are those which are consistent with the export oriented form of capital accumulation. In this context we see that the sectors netting the bulk of Germany's trade surpluses exhibit also net balances in their trade with China (not with Japan, though). The same observation holds for Sweden and Finland. In the Dutch case the overall external surplus overwhelms the deficits with China and Japan. Passive deficits are those that hamper export oriented accumulation. Italy and France are the leaders of this group since Spain is still far behind in terms of home grown industrial, not financial, inventiveness. The sectors that are good export performers for France and Italy are not so when it comes to their trade with China and East Asia. Furthermore these sectors are increasingly competed against by Chinese products in third markets and in Europe. Therefore the contribution to export oriented accumulation by the sectors on which the external projection of those countries depends does not have a solid basis. It periodically undermines their global neomercantilist objectives, and induces a deepening of the hierarchy of capitalist models and job and inequality at the European scale. Especially in the Italian case, we witness a capitalist growth which may be sometimes vital and accelerated, but which is also affected by a constitutive fragility, and can survive only at the price of a continuous restructuring. Although the UK has the largest EU deficit with China and Japan we have not included her in the France-Italy-Spain group. This is because these issues do not belong to Britain's political economy. British policy makers and British capitalism in general have given up on export led growth since the end of the first Wilson government. The task of covering for the current account deficit falls upon the financial sector and on capital movements through the City of London.

Notice that this has got little to do with the actual size of the industrial sector in Britain. The value of its output is actually marginally higher than that of France's industry and just below Italy's. Indeed by the end of the 19th century, Britain, which had an industrial sector second in size only to that of the United States, focused on capital based financial flows to finance its growing current account deficits which, eventually (1913), became unsustainable in the context of the Gold Standard.

For whom should Europe (EU) work? For Germany the European Union is (rather, was until 2007/8, before the unraveling of the world financial system) the main area of profitable effective demand. It is the area where the Federal Republic's economy realizes most of its external surpluses. These in turn represent the financial means with which German corporations internationalize their activities in the rest of the world. Whether the internationalization happens through FDI, acquisitions, or mega joint projects – such as the building with Chinese partners of the Beijing-Lhasa railway line, or the possible participation with China in the yet to be finalized construction of the Santos-Antofagasta line – will depend on the circumstances. Yet

they must all be consistent with persistent, possibly growing external surpluses of the macro economy of the Bundesrepublik. These net balances are mostly obtained in European markets.

In this context the present crisis, which is hitting German exports hard, is a major challenge for German capitalism as a whole. For years German business leaders, as regularly reported by the *Financial Times*, argued that a slow growing economy was just fine, provided it kept its advanced machinery, chemical and auto sectors to generate (rising) external surpluses. Chancellor Merkel reiterated the untouchable status of the German foreign surplus seeking economy in an interview to the *Financial Times* on March 27 2009. Few days later Martin Wolf perfectly clinched the weakness inherent in the German stance:

> In last week's FT interview with Angela Merkel, the German chancellor said that: "The German economy is very reliant on exports, and this is not something you can change in two years." Moreover, "It is not something we even want to change." To paraphrase: "The rest of the world needs to find a way of absorbing our excess supply, but sustainably, please." Yet what happens if that cannot be achieved for the excess potential supply of all surplus countries together? (Wolf 2009).

The answer is straightforward: what will happen is simply a deepening recession/depression. But the intra EU export surplus model of capitalist accumulation is so embedded in the very institutional functioning of intra EU relations and especially between Germany and France, that EU policy makers and businesses have no policy answer to the question. The only response from both Germany and France is to reject coordinated demand oriented policies lest spending by one country boost the exports of another, within Europe itself. Yet for Germany the present crisis is tearing apart the export surplus mechanism within its own area of profitable demand.

As far as Germany, Italy, France, Benelux, Austria and Scandinavia are concerned, the transmission mechanism of the crisis is not through the debt deflation affecting households since the level of personal indebtedness has been much lower than in the USA and in the UK. Hence it is not the landesbanken crisis in Germany that created the fall in German output and employment, nor did the crisis of the BNP-Pays Bas three hedge funds sink the French economy. They were ingredients in the cocktail but more as symptoms than triggering factors. The reasons for the sharp repercussions of the crisis which began in the United States can be identified in the following factors:

1. The first pertains to the state of expectations affecting investment in the pure Keynesian sense. The EU situation was already very brittle. The economies of the Euro zone were mired in a competitive wage deflation and in a 'stingy' budgetary environment. Thus effective demand creation was, on the aggregate, weak and what mattered was the attainment of export surpluses. It did not take long to realize that, without any intra EU dynamic, acknowledged by most, the real US crisis will become, sooner rather than later, a real European crisis.

2. Within the EU there are 3 areas in debt deflation crisis: the United Kingdom, Spain, and Eastern Europe. These areas absorb a significant amount of exports from the surplus and surplus seeking countries. German exports to Eastern Europe hover around 9% of the German total, the same share as exports to the USA. The crisis of Eastern Europe is rendered more acute by the absence of a growth area on which to pin their hopes. The Asian crisis of 1997-98 was eventually overcome by exports drives towards the USA and, for Korea and Taiwan, towards China.

3. The UK and the Iberian Peninsula have been absorbing more than 13% of the BRD exports. These are all areas generating net balances. Furthermore, the UK and the Iberian Peninsula are important outlets for France and for Italy who is also a net exporter to France. Transmission has come through the mortgage and financial crisis in Britain and the explosion of the housing bubble in Spain. As frequently remarked in the financial press, the real estate price inflation in Spain was connected to the financial mortgage markets in Britain and also in the USA.

It follows that Europe receives waves of financial shocks form the United States while being stuck in its own neomercantilist cage, without any way out. Europe is becoming a model case for the Baran-Sweezy-Magdoff-Sylos Labini stagnationist thesis.

11. Neoliberalism and social liberalism

The model of the 'new capitalism' was certainly neoliberal but the State has never withdrawn. It has implemented neoliberal polices in relation to the welfare state, the labor market and the environment, but it has protected monopolies and large corporations' rent seeking property rights. It did not refrain from running large public deficits, and so on. Social liberalism is perhaps more free market oriented than neoliberalism.

Social-liberals are worried not only by State failures but also by market failures, and they proclaim to be in favor both of more State together with more free market. Unlike the neo-liberals they sincerely strive for more competition in markets for goods and services; in this way they are more for 'free competition' than the neo-liberals are. They also advocate a greater regulatory role for the State ("liberalize in order to re-regulate" is their manifesto). They want a redistributive State in relation to the labor market and to welfare. For the former they do advocate labor flexibility, yet cushioned by a social protective network and by guarantees enforced through State regulations. They push for a form of universal welfare including guaranteed minimum incomes labeled with new terms such as *citizenship's income*, *basic unconditional income*, etc.

Social-liberals know that an indiscriminate attack on the Welfare State or on labor would impact negatively on the productivity of the latter. More than that: no social-liberal would deny the supporting role of State intervention as an essential provider of demand, nor would they reject the role of the Central Bank as a lender of last resort in a crisis. They would even worry and propose something against financial instability. In short, they are a bit Keynesian, according to circumstances. They claim to be in

favor of strong industrial and credit policies with structural objectives, while being at the same time strongly against any direct State intervention by means of even indicative plans, lest they stand accused of *étatism*. In general social liberals talk about these issues when in opposition, while in office they focus on financial tightness as a prerequisite for more competitive policies.

In the above context to day's truth is that social liberalism has been wiped out by far more than neoliberalism. The representatives of the latter have seen that the chains of bubbles were leading to a disaster, which actually materialized but, perhaps less catastrophically than otherwise. They made central banks abandon inflation targeting rules, adopted indiscriminate moral hazard enhancing policies which are anathema for social-liberals. This when, with the world wide fragmentation of labor, social movements are just about non existent and the hegemony is firmly with the people and classes who were in the driving seat all along.

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