

The Dissolution of the Financial State

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Abstract

The growth of a neo-liberal financial sector is evident in the post WW2 era. The key assertion of the paper is that the transformation of finance, leading to an erosion of (state) financial sovereignty, has not been driven by monetary factors alone but has, instead, mainly resulted from the tendency for the rate of profit to fall across periods of production. In an empirical study of the UK and German profit rate(s), it is discovered that the historic-cost, current-cost and MELT adjusted (historic) profit rates have demonstrated a secular decline since the Great Depression (when the means of production were marked down). In addition, following Kliman, any *restoration* of profit rates established, since the 1970's, has not been sustained (Kliman 2010). As a consequence, firms have sought new avenues of profitability and, a migration of surplus capital towards the financial sector has taken place. It is these processes that have led, it is argued, to the neo-liberal era of banking, and the subsequent erosion of state financial sovereignty. It is noted, however, that there are various counter-tendencies which mitigate (or eliminate) the falling profitability and some of these are noted. In the last three decades, for instance, shorter IT product life-cycles have led to increased *moral depreciation*. This has resulted in capitalist losses for some capitals, and increased concentration, but restored profit for others. Finally, the rise of non-banks, and competing currencies, is (perhaps) *prima facie* evidence of non-financial capitalist attempts to secure a larger share of surplus value that previously accrued to economic agents in the financial sector (Mouatt, Adams 2011).

Key Words Financial Sector Transformation, Marxist Political Economy, Temporal Single System Interpretation, Non-Banks

Introduction

The central arguments of this paper build on some research undertaken during the preparation of a co-edited book (published in 2011) that traced the development of capitalist credit relations from the early discounting of bills of exchange, prior to the industrial revolution, to the current neoliberal era (Mouatt, Adams 2011). In general, the retail/investment financial services of banks have evolved to cater for the needs of a productive sector reasonably well but that, the cartelization of the finance sector has led to the continued extraction of monopoly rents, and recent liberalization has led to a greater propensity to crisis and erosion of state sovereignty. Capitalist banking has been a largely private affair in the UK since, as Chick has observed, Charles I interfered with the mint in 1640 and, merchants and wealth-holders began to trust the services of private banks in replace of the state (Chick 2013). In conjunction with the now prevalent (endogenously-created) commercial paper in circulation,

goldsmith activity (including fractional reserve banking) and the establishment of the state-sanctioned (private) Bank of England (BOE) in 1694, a *private* financial system was now embedded as capitalism began the transition from mercantilist to industrial phase. The BOE, it is argued in this paper, has served to protect this (privileged) private banking system since.

Yet, after the Great Depression and WW2, as the state grew in size and scope, the Keynesian synthesis dominated UK policy-circles leading to pro-active economic management. It is argued that this intervention extended towards the financial sector, albeit with an exaggerated rhetoric, that manifested in central bank nationalization, exchange controls, a fixed exchange-rate regime and effective persuasion of bank behavior. Yet, throughout the Bretton Woods era, as Helleiner has argued, the private banks consistently lobbied the political arena until financial liberalization was achieved (Helleiner 1994). As a consequence, it is argued, the state capability to influence the level of credit (and its allocation) and the purchase-value of money has been somewhat undermined. In addition, the neoliberal era has witnessed the, now international, phenomenal growth of foreign exchange, off-shore currency, capital and derivative markets.

The title of this paper suggests that there is an analogy to be drawn between the dissolution of the monasteries, during the reign of Henry VIII, and the transition from the golden age to the neo-liberal financial order. The monasteries, as seats of theological study, strengthened the acceptance of papal edicts and the ideology of the infallibility of the Pope. It was deemed necessary, therefore, to remove their influence in order for the reformation to succeed. In this sense, it is argued, the post-WW2 state viewed it necessary to remove the remnants of Keynes' monetary ideas from the state policy arena, to facilitate acceptance of the neoliberal financial transition. A view that resonates with the post-Keynesian academics who, perhaps, hope that the ideas can be rekindled, albeit in a purer form than existed during the synthesis.

Yet, what are the key drivers of this evolutionary process? Several monetary (and political theorists e.g. Germain) thinkers have made important contributions towards an explanation of this financial sector transformation but, it is argued that Marx's *law of value* and his general political economy, combined with the post-Keynesian (PK) endogenous money paradigm (EMP), makes the most sense of the phenomena (Germain 1998). It is also argued that agent behavior in the productive and financial sectors determines decision-making in both sectors, in a reflexive sense, but that production is the key driver. The paper begins with a statement of the EMP, as a realistic view of modern money, and then discusses Marx's specific ideas. Empirical data is then presented, for the UK and Germany, which provides *prima facie* evidence of the theoretical argument(s) made in the paper. The paper concludes that, if the survival of capitalism in its present form is the primary objective, then policies that facilitate the restoration of profitability, and a fully regulated financial sector, are the key. This will involve, however, a reversal of the (financial) reformation that has taken place.

Endogenous Money Paradigm

Credit-money units, in the form of bank deposits, represent a monetarisation of credit in contemporary systems since they fulfill the function of means of exchange, value-store and account and can, therefore, be considered money proper. In addition, following Knapp, since the monies can be used for the payment of tax, the legitimization enhances the plausibility of the definition (Knapp 1924). Bank credit is provided in response to demand at a given interest rate. Yet, it is now *not* necessary for there to be an actual physical presence of deposits, in

order for lending to take place, since credit-money is formed *ex nihilo* as an accounting entry on asset/liability sheets, rather than as a transfer of a fixed physical entity. Also, any demand for reserves, as Wray notes, is simply *accommodated* by the central bank (Wray 2007). In this sense, the national bank functions, as Chick noted (p.7) as a ‘lender of first resort’ (Chick 1986). The state retains the capability to set (base) interest rates endogenously (and other monetary practices), and influences the spectrum of market rates, but it is argued that their capability has waned as a consequence of the transition from Bretton Woods to neoliberal era. I have dealt with this latter point extensively in other papers and will not discuss it here, except to posit that the state now has less capability to influence credit volume (and allocation) and/or money-value, in the form of national (and international) purchasing power.

There is some debate, however, between structuralist and horizontalist views of endogenous money-issue, in response to demand at the state determined short-term interest rate. In the horizontalist conception e.g. Moore, the banks simply expand credit completely in response to demand, forming a horizontal supply curve (Moore 1988). In the structuralist conception, conversely, banks require higher interest rates at larger volumes of credit (Wray 2004). Be that as it may, credit money comes in to existence when credit is created and ceases to exist when credit is destroyed. It is bank money (rather than narrow money) that constitutes the vast bulk of our currency transactions. The diagram below (Figure1) illustrates the extent of the nominal growth of this bank credit-money in the neoliberal era. This gives, it is argued, agents in the private bank sector more control over the fluctuating levels and allocation of circulating currency, in relation to the state, according to bank conditions of supply. Narrow money, conversely, is supplied by the state according to their own particular conditions of supply and objectives. In short, capitalist money is primarily credit and the increase of its private control, securitization and (growing) size of financial markets has taken place to the detriment of the state’s regulatory capacity. Yet, how can this political process be explained?

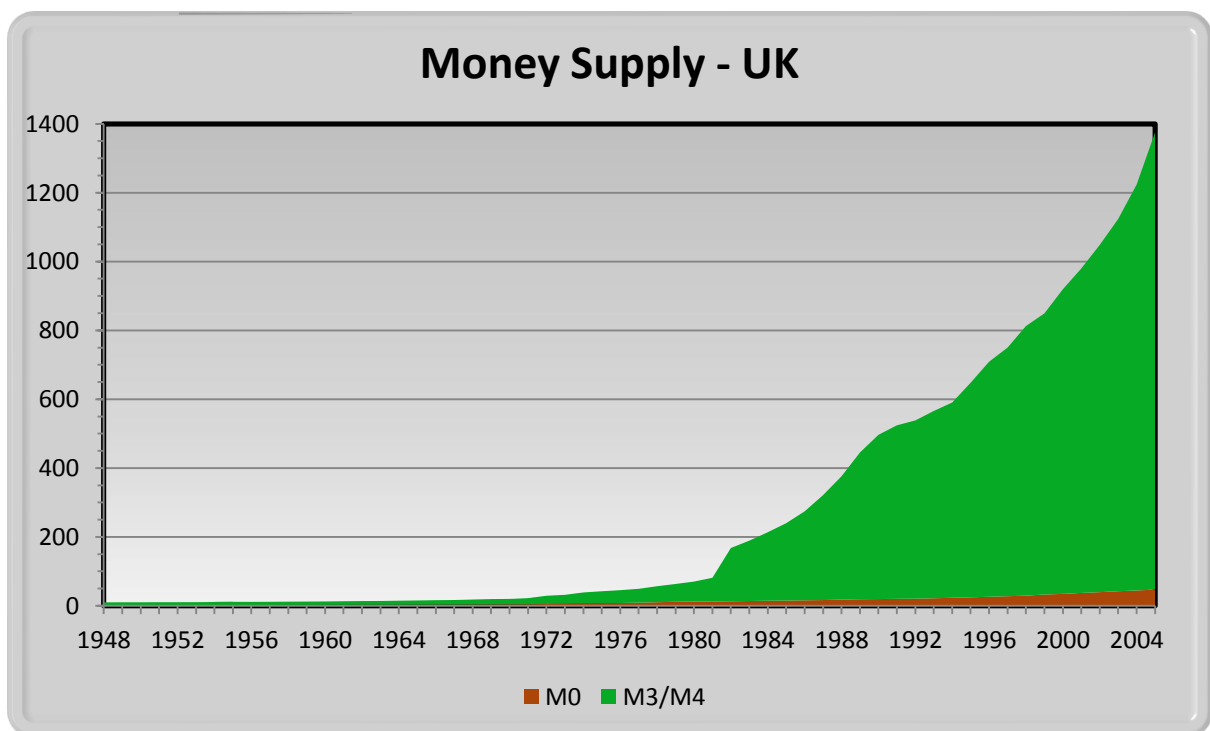


Figure 1: The changing ratio of broad to narrow money illustrates the growth of credit-money (IMF: International Financial Statistics)

A Marxist View of the State

The Marxist (class) conception of the state, following Marx, is that it simply represents an extension of the interests of capital (Miliband 1969, Poulantzas 1974, Miliband 1977). In the theme of this paper, the state is, therefore, protecting the firms in the financial sector in their quest for neoliberalism and its associated profitability. These Marx ideas have been theorised from the perspective of earlier competitive capitalism and, the more recent, monopoly capitalist form (Miliband 1969). The interests of the capitalist class can be considered to be *inter alia* the protection of private property (means of production), a legal infrastructure, state-supported (capitalist) banking, free markets, minimal regulation and competition law. If we examine the historical activities of the state in the capitalist nations, over the last five centuries, it is difficult to convincingly argue that these core capitalist essentials have been under serious threat at any point. Also, as Kliman has argued, the state is often involved in direct action to protect the system from crisis or collapse in what has been termed ‘state capitalism’ (Kliman 2008).¹ Be that as it may, the Marxist view can be separated into two distinct viewpoints, even though they amount to the same political outcome. The first, associated with the ideas of Nicos Poulantzas and Goran Therborn *et al*, identifies a political structure where the institutional entities that constitute the state are clearly formed from class relations *per se* (Barrow 1993). The second viewpoint, conversely, suggests that the political process has a power balance, at any particular point in time, which is consistently biased towards maintaining the interests of the capitalist class (Olin-Wright 2002). The Keynesian synthesis ideology had dominated during the golden age, but the removal of these ideas from policy circles was predicated on the monetarist challenge.² The financial sector was clearly a benefactor as a consequence. Figure 2 illustrates the increasing profitability of the sector.

¹ Andrew Kliman attributes the term ‘state capitalism’ to Ray Dunayevskaya (Kliman 2010).

² The IS/LM curves (of the Keynesian synthesis era) suggested that the demand for money (inverse of circulation velocity) was interest sensitive. Friedman had studies to show a stable velocity. Yet, the EMP ideas of credit creation accommodating the demand for money, as Tily noted, came too late to prevent the monetarist challenge to the Keynesian orthodoxy (Tily 2007).

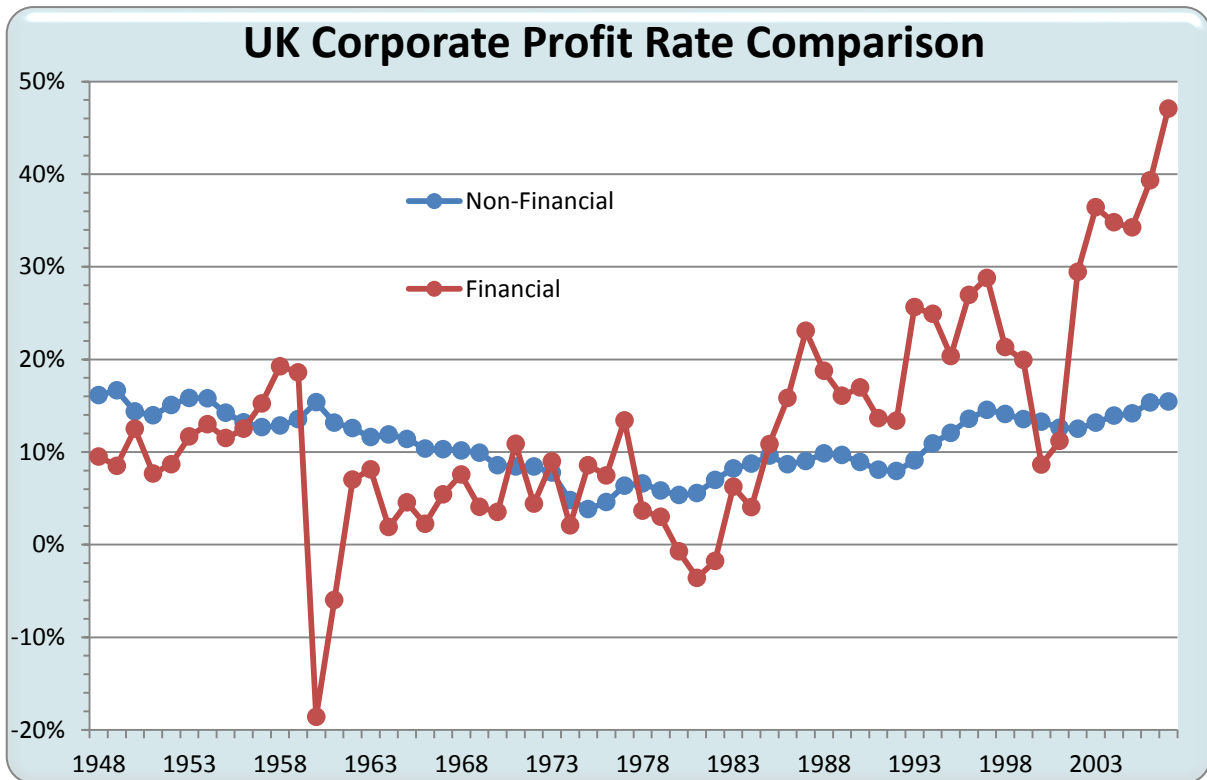


Figure 2: Relative profit of financial and non-financial firms in the post-WW2 era (ONS)

Marx's notion of the state is normally challenged with reference to the liberal democratic state presented as having a *pluralist* nature. The state is seen as autonomous from the interests of private capital (or any other interested party) and operates in the midst of a disparate plurality of powers e.g. business, banks, societal groups, external forces etc. (Ball 1977). It is in the political process that this power *mélange* determines outcomes. Yet, this does not detract from the observed reality, it is argued, which appears to demonstrate that the *key* interests of capital have remained unchallenged (in any serious way) in the modern era.

Later Marxist thinkers, have developed new ideas. The *Gramsci* inspired Cox, for instance, enables a much broader concept of world order, which takes account of recent globalisation, identifying power relations at varying levels instead. Cox focuses on 'classes' rather than states whose condition (in a Marxian sense) is determined by their material relations in the (now global) production structure (Cox 1987). Global financial markets, and currencies, represent claims on these resources. Since the production structure creates the *resources* that are indispensable to other sources of power (e.g. military power) the relations (hierarchies) of production are responsible for forming political authority – the state. The state, in turn, reinforces the same political hierarchies of production that galvanise a 'system of accumulation'. In this sense power and wealth are accumulated by the 'exploitation' of some groups over others (Strange 1988). The French 'regulation' school with their theory of 'regimes of accumulation share this view' (Lipietz 1983). Gramsci (and Cox) was also not merely concerned with the material relations of production since the existence of *consciousness*, which finds its form in dominant paradigms and ideologies (called the *blocco storico* in Gramsci's Italian context or hegemonic historic blocs in Cox's), is a prime driver of human behavior as well (Cox 1987, Gramsci 1991). Yet, of course (following Marx), the hegemonic bloc, in terms of the dominant ideological paradigm, is broadly a reflection of the

values pertaining to the production structure anyway. Marx had recognised, as Lipietz noted, the ‘enchanted world’ of appearances and subjectivity as an instigator of specific human outcomes, although it would be reasonable to suggest that he viewed these as secondary to the material relations of production and the ‘law of value’(Lipietz 1983).

Tendency for the Rate of Profit to Fall

Marx viewed the tendency for the profit rate to fall (LTFRP), as Kliman notes (p.3) his most significant contribution to political economy and the underlying driver in the accumulation process (Kliman 2010). In general, profitability can be expected to tendentially equalise between sectors, as capital migrates towards higher returns, although within sectors it does not tend to equalise. This is because introducing labour-saving technologies is profitable for leading firms, in a particular sector, as it creates a transfer of profit from other firms in that branch of industry.³ Non-leading firms (laggards), in time, will adopt labour-saving techniques but by this later stage will not be able to realise any surplus profit. If they do not try to catch up, conversely, they are unlikely to make a profit at all. Since the leading firms, as Potts notes, realise surplus profits they are better placed to invest in research and development and are thus likely to remain as the leading firms (2007). So, according to Marx, as the capitalist mode of production evolves, competitive firms introduce labour-saving technologies in order to increase productivity. Yet, when such an increase in the *organic composition of capital* actually occurs, Marx states (p.318):

Then this gradual growth in the constant capital, in relation to the variable, must necessarily result in a *gradual fall in the general rate of profit*, given that the rate of surplus-value, or the level of the exploitation of labour by capital, remains the same.
(Marx 1981)

Increases in productivity thus lower the labour-value of individual commodities and, given healthy competition, should also lead to a reduction in prices. Kliman notes (p.16) that even monopolies are likely to lower their prices when their costs of production fall, since they are then able to increase their sales and (hence) increase their mass of profit (Kliman 2012). The TSSI of Marx, importantly, has reclaimed Marx’s LTFRP from the position of simultaneous Marxists who have assumed that profitability is based on physical quantities of output (Freeman 1996, Kliman 2007, Potts 2009). Kliman explains how the use of simultaneous modelling to explain Marx leads inevitably to *physicalism*, where physical quantities determine surplus value and the profit rate, and it is then rational to reject the LTFRP on theoretical grounds as Okishio did in 1961 (Kliman 2007). However, since the TSSI has re-legitimised the consistency of Marx’s original method, it then becomes possible to utilise the LTFRP for purposes of theoretical explanation. This prediction of the *tendential* behaviour of the productive economy, based on the Marx law of value, is thus presented in this paper for purposes of analysing financial sector transformation.

It is also important to note that, for Marx, the falling (general) profit rate law in capitalist mechanics was simply a *tendency* that, by implication, was subject to counter-tendencies. If the rate of exploitation is increased, for instance, then the profit rate will be raised (assuming

³ In Marx’s political economy, as Kliman notes (p.22), the unit-value does not depend on the activities of the individual firm but the average. If a firm produces twice as much output as before, with the same labour, they produce (and, hopefully realise in monies) *almost* double the labour-value (Kliman 2007).

nothing else changes). This can occur, as Marx describes (p.432), as a result of a prolonging of the working day, an increase of *absolute* surplus value, or if the worker is worked more intensely, an increase of *relative* surplus value takes place (Marx 1976). The impact of the cheapening of commodities, which results from the increase of productivity, then leads to an increase in the rate of (relative) surplus value since the worker requires less commodities (in terms of their labour-value) for their subsistence.

Marx argued that the profit rate is restored through a crisis, reducing the prices of the means of production (and through capitalists finding it easier to increase exploitation). In crisis, with capital assets lying idle, there is a *physical* deterioration (entropy) of capital value when (p.289) capital 'falls prey to the destructive power of natural processes' (Marx 1976). In addition, there is the process of what Marx called the *moral depreciation* of fixed assets that occurs as a consequence of the price of means of production falling in crisis due to obsolescence. During crises, these asset write-downs have the effect of cheapening the means of production and, therefore, increasing the profit rate accordingly. This is illustrated in its extreme in a crisis, when a capitalist goes bankrupt, liquidating assets, and a new capitalist buys the firm at a reduced fire sale price. Any combination of these mitigating factors outlined above will, of course, (as stated) reduce the prices paid for the means of production and, therefore, restore the profit rate. These processes, as Kliman notes (p.210) lead to the destruction of capital that, in turn, is a central element of what Schumpeter dubbed the *creative destruction* of the capitalist mode of production that induces technological revolutions and cycles (Kliman 2012).⁴ In this competitive capitalist environment, firms need to be vigilant in order to protect their survival and, profitability strengthens their position by providing resources for *inter alia* research and development. Leading producers, as stated, are then able to appropriate (realise) more surplus value than they produce, in contrast to average or laggard producers, as a consequence of their superior productivity. Laggard firms are not so fortunate, however, and they often find themselves squeezed out of the market altogether. The fall in profit rates, as the economy accumulates in boom, is (perhaps) even more remarkable when it is considered in conjunction with any of the (above mentioned) mitigating factors that may be counteracting the tendency for the fall. This paper argues, therefore, in line with Marx, that *this law of the tendency for the rate of profit to fall has led to increased systemic need (and practice) to compensate through mitigating factors and this, in turn, has led (albeit indirectly) to the changes experienced in the financial system.* Marx had noted, for instance, the increasing role that banks played in the accumulation process generally. He writes (p.777), with remarkable prophetic vision of the corporate-raider activities of (leveraged) private equity firms in more modern times, that the *credit system*:

In its first stages, this system furtively creeps in as the humble assistant of accumulation, drawing into the hands of individual or associated capitalists by invisible threads the money resources, which lie scattered in larger or smaller amounts over the surface of society; but it soon becomes a new and terrible weapon in the battle of competition and is finally transformed into an enormous social mechanism for the centralisation of capitals.

(Marx 1976)

In this passage, Marx indicates that credit monies and related banking activities are important elements of the capital accumulation (and centralisation) of capitalism, since they determine

⁴ The shorter technological lifespan of fixed assets has also led, according to Mandel (p.59), to shorter business cycles (which he links to the life of fixed assets) as a result of the moral depreciation (Mandel 1969).

real *outcomes* in the competitive process. Marx argued they would facilitate the centralisation of the means of production, in a decreasing class of capitalists, and fosters the concentration of capital in ever larger (joint-stock) units. This process has indeed continued unabated in the history of capitalist economies. Marx thus maintained that the *key* driving forces (and mechanics) of capitalism emanate from *production* itself and, in particular, general accumulation and the tendency for the profit rate to fall as (objective) laws of operation.

It is claimed in the paper that the LTFRP (directly or indirectly) impacts and transforms the financial sector, also eroding state financial sovereignty, and then later leads (in the absence of counter-tendencies) to crisis. It is important, therefore, to outline these processes in more detail since they are significant for the later empirical analysis. We first consider the Potts description, derived from Grossman, and then Kliman's approach in order to illuminate some of the processes (Potts 2010, Kliman 2012).

Potts argues that the migration of surplus capital (assuming this exists) towards the financial markets, and thus any subsequent financial sector development that erodes state financial sovereignty, is driven by a falling profit rate as capital seeks higher returns (Potts 2010). He defines surplus capital as (p.75) simply the monies that remain when capitalists cut back on productive investment, following a fall in the profit rate (Potts 2011). Marx writes (p.349):

The rate of profit, is the spur to capitalist production (in the same way as the valorisation of capital is its sole purpose), a fall in this rate slows down the formation of new, independent capitals and thus appears as a threat to the development of the capitalist production process; it promotes overproduction, speculation and crises, and leads to the existence of *excess capital* [my emphasis] alongside a surplus population. (Marx 1981)

Potts then further illustrates (p.77) how Grossmann (in 1929) had employed Marx's concept of surplus capital to (accurately) predict the imminence of crises, in the form of the Great Depression, as a consequence of the 'superfluity' of capital, poor investment prospects and rising unemployment (Potts 2011). Grossmann writes (p.191):

Superfluous capital looks for spheres of profitable investment. With no chance in production, capital is either exported or switched to speculation. ... Despite the optimism of many bourgeois writers who think that the Americans have succeeded in solving the problem of crises and creating economic stability, there are enough signs to suggest that America is fast approaching a state of over accumulation. ... The depressed state of industry is reflected by an expansion of speculative loans and speculative driving up of share prices. ... Today's America is doing its best to avert the coming crash – already foreshadowed in the panic selling on the stock exchange of December 1928 – by forcing up the volume of exports. ... When the Germans and the British match these efforts, the crisis will only be intensified (Grossmann 1977 [1941])

In a model that Potts developed in 2009 (p.76), Potts illustrates how the return on shares for a (theoretical) company, that keeps wages constant (in use-value terms) and experiences rising productivity (and thus a rising rate of exploitation), will rise as the mass of surplus value rises in boom despite falling profit rates (Potts 2011). A point arises in the simulation, where the return on the shares exceeds that of investing in production. Capitalists then switch to investing in fictitious capital further reducing productive investment and stimulating more

share-price inflation. These bullish conditions continue until a stock market crash ensues. As Potts notes (p.78):

Rather than explaining bubbles in terms of pure speculation, the concept of surplus capital explains why such bubbles should cyclically reoccur. It is not a matter of irrationality; it is simply a consequence of supply and demand. If productive capitalists wish to productively invest less, the financial system is left with more capital to invest elsewhere (Potts 2011)

It is interesting to note, as Grossmann had pointed out (p.199) that the Hilferding notion of integration between banks and firms, with banks driving outcomes, is an unrealistic one:

Hilferding's exposition contradicts the actual tendencies of development of capitalism. It is also incompatible with the fundamental ideas of Marx's theory. For if Hilferding were right in arguing that the banks dominate industry, this would only shatter Marx's theory of the crucial importance of production itself to the structure of capitalism. The crucial role would then be played not by the production process but by finance capital, or structures in the sphere of circulation. ... At more advanced stages of accumulation industry becomes increasingly more independent of credit flow because it shifts to self-financing through depreciation and reserves. ... In countries like Britain, France and especially the USA, it is simply not possible to speak of industry being dependent on the banks. ... According to Vogelstein, this is one of the reasons why banks have been turning to the stock exchange by way of investments (Grossmann 1977 [1941])

Grossmann points out here that, as Potts notes (p.78), banks can only perform a leading role in business behaviour if capital is in short supply (Potts 2011). In addition, it is rather the surplus capital, Potts argues (p.78), derived from low profitability (in the productive sector) that is the more (it is argued in this study) plausible crisis explanation than attributing crisis to financial factors (Potts 2011).

Kliman has a similar approach to the same issue, except for a slight difference as a direct consequence of his empirical work. Kliman discovered that, in his study of the US economy since the Great Depression, the rate of accumulation has tracked the profit rate very closely, suggesting that the proportion of profit used for productive investment has remained constant leading to sluggish growth and speculations. He, therefore, does not emphasise the idea of capitalists cutting back on investment, following low profitability, and creating surplus profits that then migrate to the financial markets. Kliman argues instead that the profit rate only *indirectly* (albeit importantly) impacts the financial sector, via *low* profitability (p.13), that then creates the instability for crises (Kliman 2012). The financial sector can, of course, leverage its own credit expansion. Kliman further notes, in addition, that falling profitability cannot be a direct cause of crisis because profitability actually rose in the years preceding the financial crisis in 2007.

But, what are the precise (albeit indirect) transmission mechanisms that Kliman identifies, linking falling profit rates to systemic crises? Kliman identifies (p.29) two such intermediate links, a lower average profit rate, and its impact on firms, and the credit system (Kliman 2010). These links will be the *same* as those responsible for the *observed* loss of (state) financial sovereignty, evidenced by increased commercial banking activity, since the same *financialisation* phenomena have led to crises. Firstly, a falling profit rate lowers the average

rate of profit. This means that even if the profit rate is rising immediately before a crisis, *marginal* (in terms of unviable) businesses will simply not be able to survive. Minimal profit is imperative, of course, for all firms. Secondly, in terms of the credit system, a falling profit rate leads to the increase of speculation and asset bubbles, followed by default of debt obligations and sharp devaluations, which then become the immediate cause of crisis. In addition, low rates of accumulation will also tend to lower interest rates, furthering speculation and asset bubbles. Marx writes about the preliminary activity, before the impact on the credit system, of a falling profit rate (p.367):

If the rate of profit falls, on the one hand we see exertions by capital, in that the individual capitalist drives down the individual value of his own particular commodities below their average social value, by using better methods, etc., and thus makes a surplus profit at the given market price; on the other hand we have swindling and general promotion of swindling, through desperate attempts in the way of new methods of production, new capital investments and new adventures, to secure some kind of extra profit, which will be independent of the general average and superior to it (the average profit rate).

(Marx 1981)

This is a key passage since it reveals how Marx perceived the impact of the tendency for the rate of profit to fall on general capitalist behavior. Firms will seek, for instance, to gain extra profit from productivity growth (promoting over-production), at the expense of other firms, before profit equalisation takes place, or seek out new investments (and new markets), mergers or financial speculations. The financial speculations can, of course, lead to excessive debt (in relation to new value creation) and asset bubbles. In addition, these are likely to be enhanced in a boom (when profitability falls) as a consequence of heightened *animal spirits*, and lower interest rates due to surplus capital. Excessive debt and asset bubbles then lead, of course, to default and burst bubbles. In short, crises soon follow.

Marx's view of the impact of falling profitability, as interpreted here by Potts, Grossman and Kliman, is posited as an explanation of general reproduction and the transformation of the financial sector. Since the credit-money system *is* our contemporary money system, and provides the generic money-entity used in productive *and* non-productive transactions, the monetary exchanges can be viewed as separate transaction categories that are subject to different forces and mechanics. The falling profit rate, therefore, impacts value-production first and, then (indirectly) impacts financial (fictitious) sector transactions through transmission signals, and/or surplus capital migration, which are based on underlying asset values of financial securities. Financial sector activity, of course, often creates clear winners and losers. Whilst all financial intermediaries providing interest-bearing capital should be expected to share (barring default) in the surplus value created in the productive economy, activity in the financial markets frequently involves profiteering from the fluctuating market prices of securities where *no* extra surplus value is created. In these instances, the exchanges are zero-sum, with varying agents experiencing simultaneous (consummate) gains and losses. In the securitised modern era, this may also be a contributory factor to the increasing further establishment of plutocracy, financial instability and the centralisation of financial power.

In the next section, we consider the post-WW2 profit rates in Germany and the UK. If a falling profit rate is identified across periods this will provide *prima facie* evidence of a migration of surplus capital, and/or increased credit expansion within the financial sector, that has fuelled the identified liberalization and profitability of the sector in the modern era.

Profitability

The key aim is to ascertain whether the profit rate has fallen, in Germany and the UK, and then discuss any correlation with the growth of (fictitious) financial markets and debt. If there is support for the view that production factors are underlying drivers of any transformation of banking these ideas will directly contrast with the view, argued by some (e.g. Moseley) that neo-liberalism has led to rising (non-financial) profitability, partly as a result of increased labour exploitation, and the position that the recent crisis was purely *financially* driven (Lapavitsas 2009, Moseley 2009). These popular views are significant since they imply that government policies could be devised to tame finance in the hope that capitalist crises can be eliminated. Kliman notes (p.9) that these finance-sector explanations are usually based on two methodological approaches. Firstly, by *cherry-picking* trough to peak years in the data studied and, secondly, by using *current cost* (valuing fixed assets by their current replacement cost) profit rates (Kliman 2010). Yet, paradoxically, as Kliman discovered in his US case study (p.49), when the latter method is chosen the current-cost profit rate can (at times) be *rising* simultaneously with a *falling* rate of accumulation (ratio of new investment to advanced capital (Kliman 2010). This finding can then be cited, by (above) advocates of the approach, as a justification for positing financial factors as drivers of crises. Kliman, in response (p.41), challenges the validity of using current cost measures in theory since they are not used by businesses or investors (who generally aim to maximise net present value estimated returns) and because current cost profits do not represent the *actual* returns to advanced capital anyway (Kliman 2010).

Kliman points out instead (p.49), that since the rate of accumulation has tracked the historic-cost (what was actually paid) profit rate very closely (in the US case study) the historic-cost profit rate is, therefore, a more appropriate measure to use (Kliman 2010).⁵ In addition, his empirical work (p.53) has revealed that post-WW2 *changes* to the profit and employee-compensation *share* of income have not been *sustained*, with the exception of a notable fall in the profit share at the end of the sixties (Kliman 2010). The US evidence (arguably similar for the UK) suggests that if explanations of rising profitability are founded on increasing labour exploitation, they are likely to be problematic. Finally, Kliman has also taken account of the increasing rate of *moral* (Marx's term) depreciation (due to obsolescence) that occurred during the information age. If this is taken into account appropriately, the actual profit rates are even lower than official estimates would suggest (Kliman 2010). In response to these considerations this paper, following Kliman, has chosen to observe the longer-term profit-rate trends and utilise historic-cost profit rates, which are then compared with current-cost calculations. In order to obtain data for UK historic profit rates, in any year, the work (due to unavailable UK data) uses reported current values and then adjusts them according to the commensurate proportion of US historic rates to current ones as proxy:⁶

$$HC^{UK} = \left[\frac{HC(US)}{CC(US)} \right] CC^{UK}$$

⁵ Changing expectations are, of course, responsible for *de facto* investment decision-making. This research takes the position that historic profit rates (and inflation-adjusted historic profit rates) are a reliable indicator of likely expectations, in conjunction with any 'animal spirits' (Keynes' notion) and current interest rate element.

⁶ It is assumed that this is a reasonable estimate of the UK historic cost measures, for fixed assets, profit and depreciation, since it is likely to be an *under-estimation* of UK assets because some of them will date further back than the US figures e.g. real estate (this is countered by the lower payments for real estate in the US).

In addition, to adjust for inflation (using Marx's procedure), the historic rates are deflated by an approximation (Kliman's method) of the MELT changes, whereby GDP is divided by employment and the changes are index linked.

Different Rates of Profit

A profit *rate* is always, by definition, a ratio of profit in terms of the capital advanced at the start of the production period. Yet, this can be calculated in different ways according to the intentions of the researcher. In the real world, as Kliman posits (p.13) the most important investment consideration for the entrepreneur is the *anticipated* profit rate, though it is difficult to measure this *expectation* objectively (Kliman 2010). The entrepreneur will be driven by many factors, of course, not least of which are the recent profit rates and interest rates. If we wish to measure historical profit rate trends, conversely, then we need to observe the actual *realised* rates achieved. Kliman points out, for instance, that if we are measuring profit in comparison to other forms of investment return (e.g. shares) then we need a narrow measure such as profits after tax. Yet, Kliman's favoured method (p.18) is the *property income* measure (which does not deduct rents, profits and interest) since this identifies the impact of (class-based) income distribution changes on the rate of profit (Kliman 2010). Finally, if we wish to analyse fluctuations in *observed* profit rates it will help to adjust the figures for inflation, using Marx's method or as a comparison the RPI, in order to gauge real returns. These real returns are an important consideration for the level of business investment. The profit measure that has been used as a numerator in this profit rate calculation is *net operating surplus* (reported by the ONS), which has been used as a proxy (it excludes net producer subsidies/taxes) for Kliman's (p.26) *property income* measure (Kliman 2010). The measures both give a closer representation of the actual profit (surplus value) generated by production, since they *include* the gross surplus (accruing to the capitalist class) in the form of interest, rent and profits.⁷ Kliman, in his study, also (p.26) calculated the US historic profit rate using profits before tax data (and including stocks in the denominator) and found that the resulting profit rate trends are very closely correlated (Kliman 2010).⁸

The historical cost profit rate (R_y) is thus profit (P_y) divided by the net fixed assets (C_y^{HC}):

$$R_y^H = \frac{P_y}{C_y(H)}$$

The MELT deflated labour rate of profit (R_y^L) is thus profit divided by the (adjusted) net fixed assets (C_y^L) as follows:

$$R_y^L = \frac{P_y / M_y}{C_y(L)}$$

Finally, the current cost rate of profit is profit divided by the current cost net fixed assets:

⁷ This is a much closer statistical measure, of course, to Marx's notion of surplus value.

⁸ It is for this reason that it was considered unnecessary to replicate the same data calculation.

$$R_y^C = \frac{P_y}{C_y(C)}$$

In Figure 3, the *historic* profit rate of the UK is illustrated.⁹ It is interesting to note that a *clear* secular decline, a 29.4% reduction, is identified between 1948 and 2007. In addition, in the Kliman US study it was also evident that, since the prices of fixed assets were marked down during the depression years, an even higher profit rate existed during the later depression years and WW2 (Kliman 2010). This means that, if we assume (arguably) there was a similar scenario in the UK, 1934-1948, there were even higher rates. In addition, the period immediately following the graph's time period was also marked by a financial (and real economy) crisis where the UK profit rate is likely to have been lowered. If these trends were added to the graph, therefore, the *fall* in the profit rate would have been even more marked. There have been times of partial restoration for the profit rate, however, notably the mid 1970's and early 1990's, but this has not been sustained.

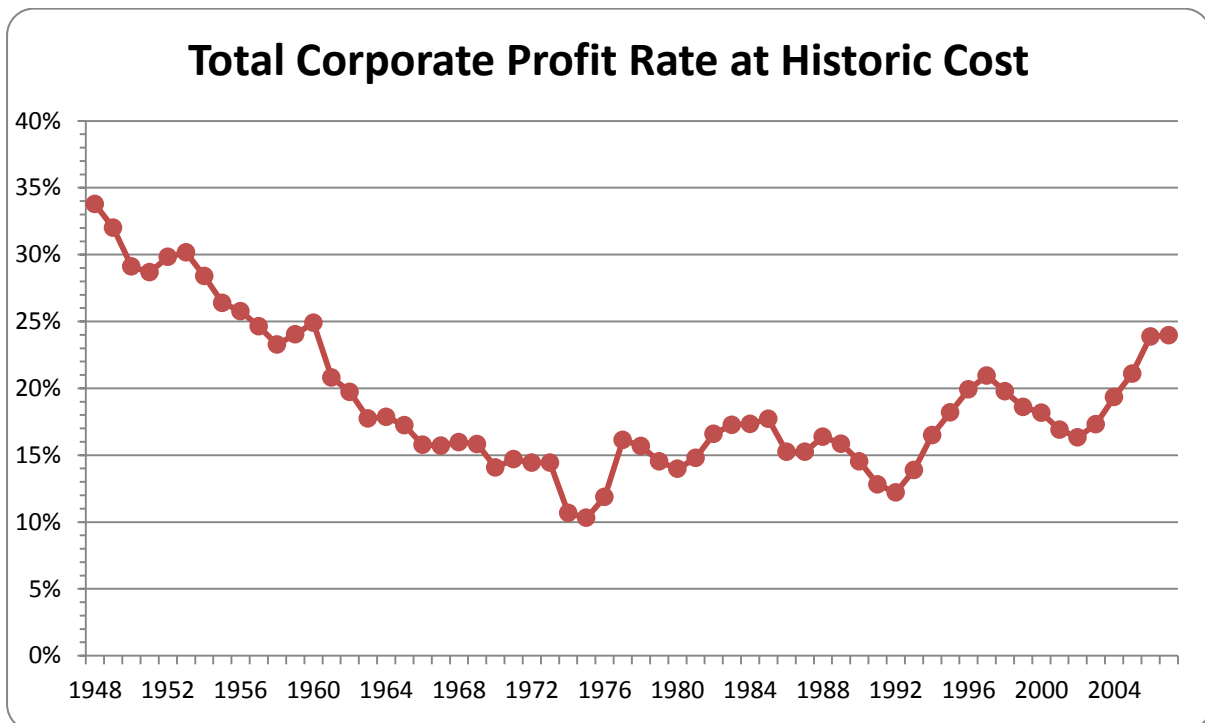


Figure 3: UK Historic Cost Profit Rate (ONS and US Bureau of Economic Analysis)

⁹ The statistics used for the approximation are (with all data used in the study) to be found in the appendices.

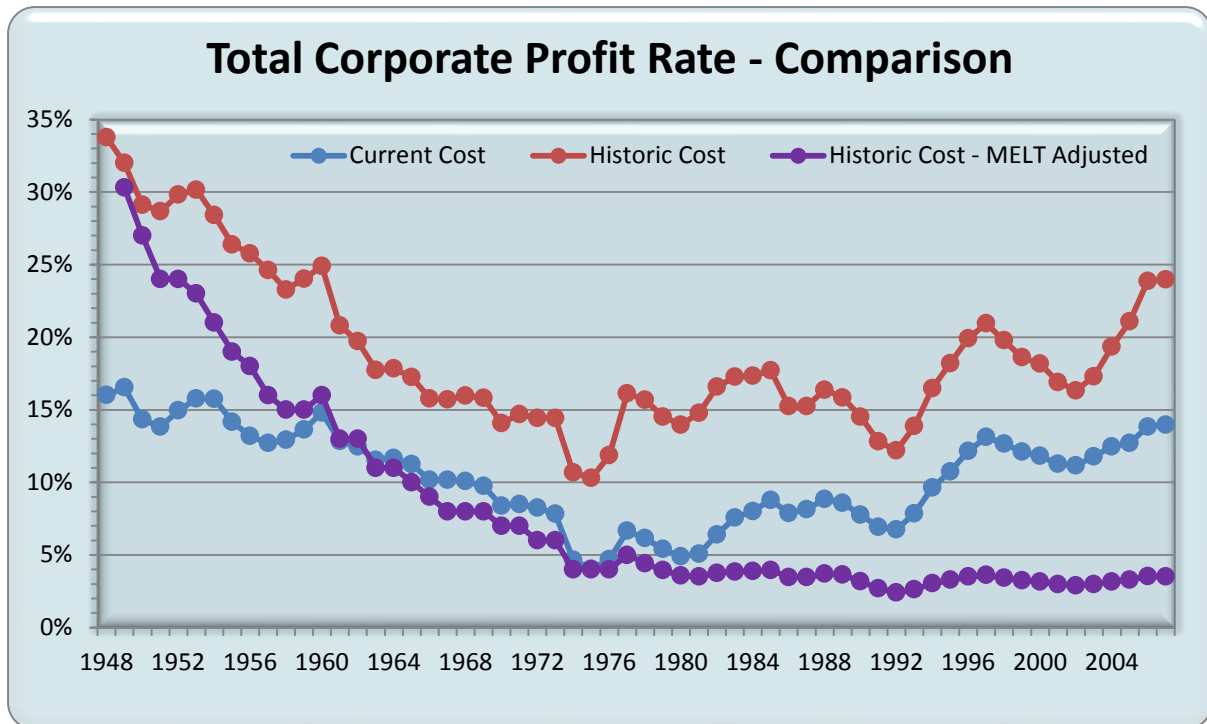


Figure 4: The UK Corporate Profit Rate Measured by Historic, MELT adjusted and Current Cost Calculation for Comparison. (UK, ONS and US Bureau of Economic Analysis)

Yet, even with current (replacement) cost calculation, a *fall* in the rate of profit in the UK of 12.5% can be identified from 1948-2007 and it fails to recover sufficiently prior to the 2007 crisis. The (likely) higher rate from WW2, and lower rate post-2007, also needs to be taken into consideration. Yet, the current cost calculation cannot really be considered a profit-rate *proper* (whilst useful) because it does not measure the *nominal* profit value (unlike historic cost) in relation to the (nominal) value of the capital actually advanced.¹⁰ It is these actual returns, of course, that entrepreneurs use to service their debt obligations (and dividends) and formulate their *perception* of general business profitability (and actual resources) that guides their future investment plans. Notwithstanding, current costs, of course, are still an integral part of the investment considerations, since they equate to the actual monies to be expended.

In Figure 4, the historic and current cost profit rates are compared. In addition, the constant MELT (historic) profit rate is represented, in order to account for the rising monetary expression of an hour of labour-time. This measure illustrates the *equivalent* prices, assuming no productivity changes, of the relevant fixed assets if paid today, by deflating the historic prices by the MELT index.¹¹ The net operating surplus, of the relevant year, is also deflated. This MELT graph reveals, interestingly, a clear fall in profit rate and, importantly, a distinct lack of recovery.

¹⁰ Corporate decision-makers can use the information, for instance, as they consider the replacement cost of advanced capital for the future. Yet, historic cost profit rate are useful for decision-makers as they contemplate historic average profit rate trends and the repayment of any debt obligations pertaining to capital.

¹¹ Since the historic cost advanced capital is measured at the start of the year, the calculations are based on the MELT deflator for the previous year.

These graphs illustrate, in a general sense, the *law of value* in operation and suggest that individual capitals are receiving *less* profit per pound advanced. UK capitalists have therefore needed to find some way to compensate themselves, manifested in a variety of particular behaviours. They may, for instance, have sought to increase the rate of exploitation, compete more intensely with rival firms, incorporate smaller capitals through acquisition or engage in their own financial sector activity (see later) or (most notably) asset speculations. In short, as argued earlier, the falling rate of profit engenders a range of profit-seeking activities, in the absence of sufficient counter-tendencies or a crisis that sufficiently marks down the values of advanced capital. The factors derived from production, it is therefore argued, can then be seen to be driving the (more general) UK systemic change that indirectly impacts the financial sector.

In Germany, profitability has been higher but a decline is still evident. This study takes the position that Germany (importantly) has been a lead producer. It was identified earlier that whilst profit equalisation between sectors is expected to tendentially occur across periods, this is not likely (though possible) within sectors. The persistence of any rents also hinders the profit equalisation process. In Germany, these are likely to have taken the form of technology rents.¹² In the following diagram, Figure 5, the current and historic cost profit rate measures for Germany are illustrated from 1970-2007.¹³ The figures reveal a *higher* corporate profit rate for Germany, in comparison to the UK, albeit closely correlated decline (and restoration) *patterns* in profit rates during the period.¹⁴ This suggests that, if the period prior to 1970 in Germany had a similar decline in profitability as the UK (which this study posits), then this has occurred from a higher starting point. Figure 6 provides estimates for the pre-1970 period (based on UK data) and also provides a MELT adjusted measure. It is argued in the paper that after currency reform in 1948 (and debt write-downs in 1953), aided by Marshall Plan monies, German firms enjoyed healthy profits post-WW2 and dynamic growth as a consequence.¹⁵

¹² The proliferation of patents facilitates the extraction of technology rents.

¹³ The statistics prior to 1970 were unobtainable.

¹⁴ The restoration of profit in the neoliberal era, however, has not been as marked.

¹⁵ The currency reform of 1948 (the new Dm) meant that many obligations were written down.

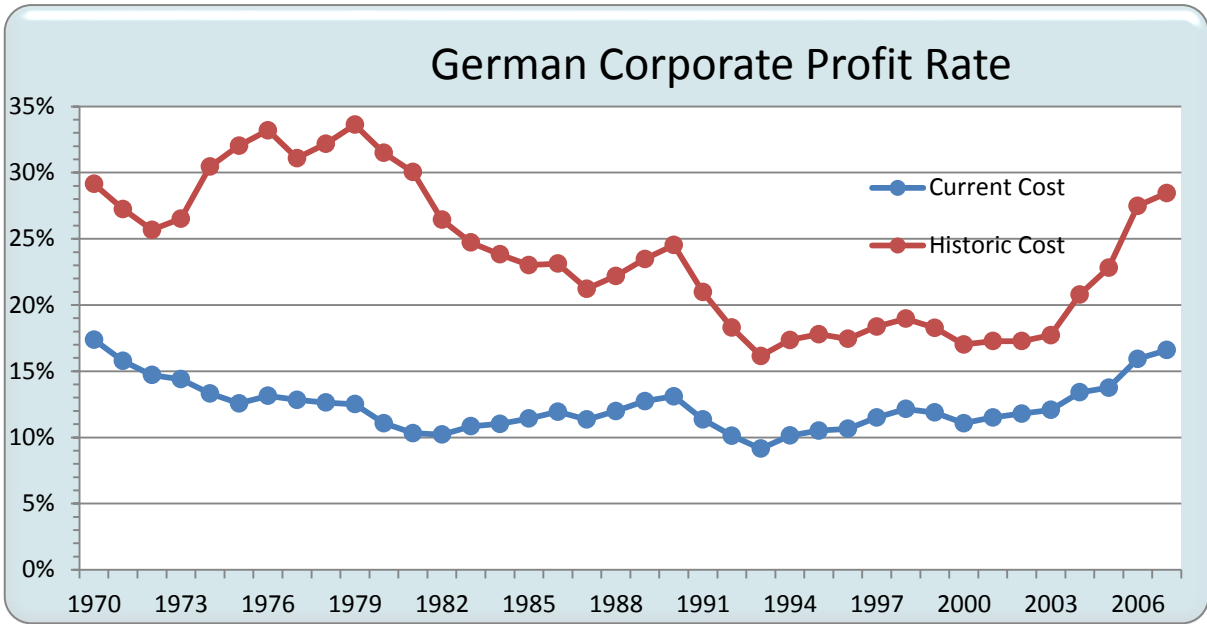


Figure 5: A Comparison of German Historic and Current Cost Profit Rates 1970-2007

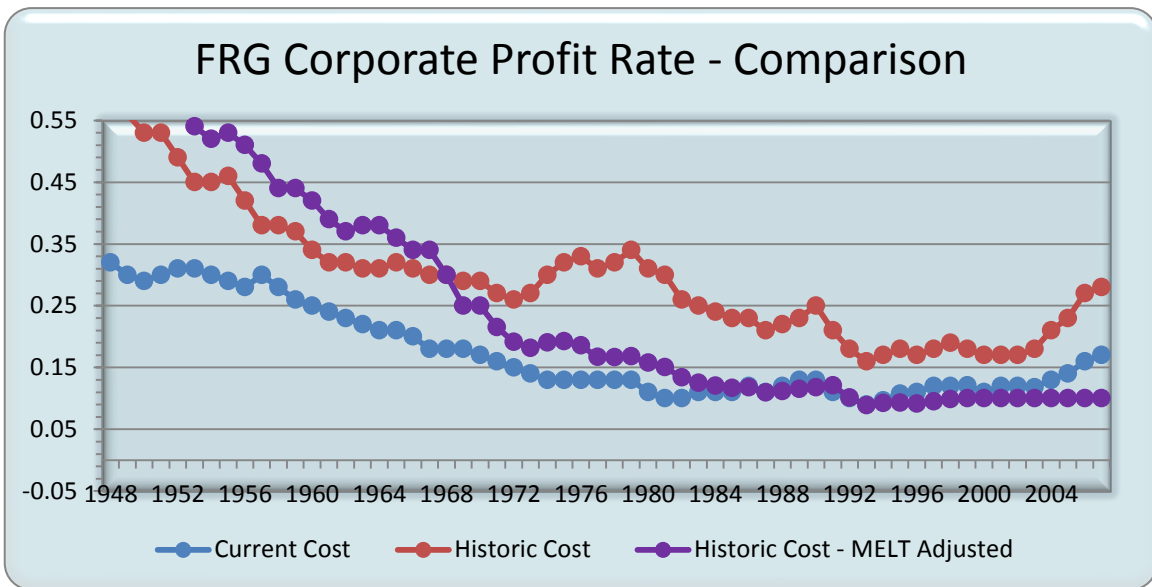


Figure 6: A Comparison of German Historic, Constant MELT and Current Cost Profit Rates with estimated values pre-1970 (Based on commensurate UK data)

If we compare these profit rate measures from post-WW2 Germany and the UK with the growth of (now international) financial markets, ignoring cycles, the correlation is clear.

Moral Depreciation

Interestingly, moral depreciation (as stated earlier) has also become much more acute during the information age, with the advent of computer hardware and software engineering. Kliman has identified (p.75), for instance, a notable rise (from 7% to 11%) in US moral depreciation

since the 1950's, which he attributes to computing, and the UK economy is very likely to display similar results (Kliman 2010). This will raise profit rates (after the initial fall) as the fixed assets are marked down. Kliman claims (p.77), that *all* of the increase in moral depreciation during the neo-liberal era can be attributed to computing. He then contends, with the use of his estimated measures of *increased* moral depreciation, that capitalist losses (unrealised surplus value) have been substantially higher since the 1980's as a consequence (Kliman 2010).¹⁶ His study (p.79) has estimated *profit rates* using a *constant* rate of moral depreciation (removing the recent *increase* of moral depreciation) and found, unsurprisingly, that the (adjusted) *fall* in the profit rate across the case-study period was even *more* marked as a consequence (Kliman 2010). These results were confirmed using profits before (and after) tax and his property income measure. This appears, therefore, to back the contention that firms are seeking to compensate for the tendency of the profit rate to fall by shortening the product life cycles (providing they predict benefit) of information age technology. This is perhaps a simple response to the systemic demands of the (latter stages of) capitalist mode of production given the LTFRP.

The Rise of the Non-Banks in the Neo-Liberal Era

Yet, even if we reject the usual Marxian prediction for the capitalist trajectory, where firms seek to realise increasingly more surplus value to offset the falling rate of profit, the generally accepted corporate (financial and non-financial) imperative is still the pursuit of profit. In the banking sector, there are fresh challenges for firms, since information age and innovation have led to new channels of financial circulation, and financial liberalisation has contributed towards a more (competitive) global economy. The companies most likely to succeed in this modern environment, as Lietaer has noted, are the ones *most* able to combine electronic knowledge systems with production. If this is extended (which it is) to the development of (non-financial) corporate monies, nonbanks and payment systems this will further strengthen their competitive position (Lietaer 2001). So, nonbanks are becoming increasingly significant in the modern financial system (Adams, Mouatt 2010). Bradford *et al* have examined their varied roles in payment activity, in both traditional and emerging systems, for instance, and identified complex relations with the banks and payment system. In addition, since they are rarely (directly) involved with final settlements, they appear, at least, to be less associated with systemic risk. In reality, of course, banks *and* nonbanks are both susceptible to operational risk (Bradford, Davies et al. 2003).

Marx, in his analysis of the *subjugation* of feudal lending practices, as capitalism developed, considered that since the function of interest-bearing capital was inextricably linked to the production process it was, therefore, dependent on it. Capitalist banking and credit developed, therefore, to service the accumulation process and, subsequently, replaced older forms of lending with a more efficient provision of financial resources Marx writes (p.468):

The commercial and interest-bearing forms of capital are older than industrial capital, which, in the capitalist mode of production, is the *basic form* of the capital relations dominating bourgeois society – and all other forms are only derived from it or

¹⁶ Kliman uses BEA data, from between 1937 and 1951, to estimate the level of normal (wear and tear) depreciation of fixed assets and then extrapolates values to estimate the relative proportion of moral and other depreciation since 1951. Kliman then calculates (p.78) that the percentage of surplus value not realised as profit (the *increased* moral depreciation) was; 28% for after-tax profits, 21% for before-tax profits and 12% for property income (Kliman 2010).

secondary: derived as is the case with interest-bearing capital; secondary means that the capital fulfills a special function (which belongs to the circulation process) as for instance commercial capital. In the course of its evolution, industrial capital must therefore *subjugate* [my emphasis] these forms and transform them into derived or special functions of itself (Marx 1971).

Yet, the modern financial sector has become more profitable (or more exploitative depending on definition) and, with recent financial innovation and electronic trading, can appear more abstract or so-called de-coupled from the *real* economy. There is an incentive, therefore, for modern non-financial capitalists, faced with squeezed profit margins, to move into the financial sector arena in the search for additional profit. This is analogous, in the modern era, to the development of early capitalist banking after feudalism that Marx was referring to in the passage cited above.

Conclusion

This paper has argued that the EMP is an accurate reflection of the nature of modern money in the capitalist nations and, that banking has undergone substantial change in the neoliberal era, leading to cartelization (and associated profiteering), an erosion of state financial sovereignty and the increased propensity towards financial crises. Marx is seen to provide us with a plausible concept of the capitalist state, which protects the interests of a private financial system, manifested in national bank system operations. The state has, therefore, been *cleansed* of its Keynesian bias in order to facilitate the change in financial order. In addition, the *law of value* of Marx (understood by non-simultaneous interpretation of Marx) and the LTFRP is used to explain how surplus capital migrates to the financial sector in search of higher returns (in conjunction with leveraged credit expansion in the finance sector itself). The impact of this (indirect) process in the real world has facilitated liberalization, financialisation and the growth of markets. It was also noted that the rise of non-banks (perhaps) reflects a perceived need of non-financial firms to secure additional profit. Finally, it is also noted, that certain factors, such as increased *moral depreciation* (and/or other factors) can influence the overall decline in profitability.

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