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## **The Analysis about the Causes of Financial Crisis in 2008 Based on Political Economics**

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**Abstract:** This paper investigates the causes of financial crisis happened in 2008. There are several reasons for it. Firstly, the virtual demand that has the purchasing power is an important reason for the crisis. Secondly, the radical contravention of capitalist mode of production is the root cause of the crisis. Moreover, Neoliberalism is also a roll booster driving the crisis. So, market economy system needs some measures, for example policies of adjustment, supervision and regulation, help to avoid the frequent economic fluctuation which produced in capitalism. They are requirements for adapting to the improvement of the socialization of production in capitalism, and they are also the result of the social evolution to more advance.

Many studies have showed the causes of the financial crisis which were very different. To summarize, there are seven representative viewpoints. (1) Limitless greed of human nature is the fundamental reasons for crisis. (2) Misplay in administrative intervention and failure in government regulation. (3) Excessive attachment to Neoliberalism and efficiency of market forces themselves. (4) Troubles in the real economy. (5) Problems in finance system and financial innovation. (6) The ravages of economic globalization that the U.S. playing a leading role. (7) The radical contravention of capitalism. This paper investigates the real causes of international financial crisis in 2008 by applying the theory of Marxist political economy and through the multiple perspectives and forms.

### **I Causes for financial crisis: The virtual demand that has payment capacity**

The American financial mortgage institutions launched subprime mortgages with zero down payment in 2001. The borrowers didn't have to make a down payment of 20 percent on a house, and lenders don't have to make a qualification examination about the background and actual income condition of borrowers. In fact, it encouraged the subprime borrowers, defined as those with lesser ability to repay the loan, to buy houses with bank loans. In the second phase, the HKMC securitizes the mortgages into Mortgage Backed Securities (MBS) and offers them for sale to investors. Mortgage-backed securities (MBS), which derive their value from mortgage payments and housing prices, had enabled financial

institutions and investors around the world to invest in the U.S housing bust. The value of USA subprime mortgages was estimated at \$120 billion in 2007. The number increased to \$1.4 trillion in 2000, and mount up to \$1.2-1.5trillion in 2007. The total amount of mortgage-backed securities issued in the secondary market got to \$10 trillion, among them, about 2/3 was circulated internationally. The number of financial institutions involved in subprime mortgage was more than 2500, including 45 world-famous large banks or securities companies.

Subprime mortgage together with the mortgage-backed securities circulated in secondary market fueled a housing market boom. Between 2002 and 2007, the price of the typical American house increased sharply and huge housing bubble formed gradually. The total value of real property in American house market amounted to about 21trillion as of the beginning of year 2007, with 38 % ( 8trillion) was for investment purposes.<sup>1</sup>In2006, interest rates in USA began to rise. At a later time, the house bubble burst, and the house prices of USA declined in February 2007. As a result, the chain of circulation of subprime mortgage broken, mortgage delinquencies soared, and securities backed with subprime mortgages, widely held by financial firms, lost most of their value. The financial crisis aroused by subprime mortgage crisis occurred and spread all over the world.

The end result is a certainty. The Law of Value, the basic economic law, and Fictitious Capital Theory revealed by Marxist political economy can explain the crisis well. The former shows that socially necessary labor-time determines the value, and the value determines the price. Disequilibrium between supply and demand generated in market exchange makes deviation between the market price and value. Market price regulates the relationship between the supply and demand through the deviation, reproduces equilibrium, and the price is toward value in the end. The exchange follows the principle of exchange at equal value (equate labor exchange). Especially, we need pay attention to the Marxist Theory of Demand. It consists of two levels. First of all, Marx said that “it was difficult to define the demand and supply, they seemed to be tautology..... if society want to meet the demand and produce certain good for this purpose, it must pay for it .In fact, because division of labor is a prerequisite of production, so the way society purchasing these goods is to produce them by utilizing a part of the labor time. That is to say, it can buy them in a certain amount of social disposable labor-time.” It is obvious that what Marx called demand here is the problem of production. Purchasing power or money (balanced currency supply and demand)the demand side had represent wealth that has a certain value(use value).The Purchasing power represents a quantity of socially necessary labor because of equivalent socially necessary labor input into production by the demand side. Actually, It supplies the use value embodying a certain amount of socially necessary labor(wealth).The difference is that money representing the wealth that demand side supply for society abstractly at present

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1 David Cotz. China Education Newspaper. 10/14/2008.

had embodies the purchasing power that can exchange for real wealth (use value). Secondly, Marx pointed out the effect what market price influenced the demand by analyzing the demand in market. “In the demand side.....based on the quantitative stipulating, the demand is flexible and variable.....If the price of means of subsistence becomes lower or monetary wages increases .....social demand for these goods will also increase.”<sup>1</sup> “If demand decreases, the market will go down accordingly. A necessary result is the escape of funds, and supply begins to slacken off.”<sup>2</sup> So, the market demand rests with the real purchasing power formed by the public’s labor for creating wealth. So far as a certain market is concerned, its demand scale determines the supply scale.

The subprime mortgage issued in America was made to subprime borrowers, defined as those with lesser ability to repay the loan based under the condition with zero first payment. The incentives such as lower interest rate and a long-term trend of rising housing prices had encouraged borrowers to assume difficult mortgages in the belief they would be able to make great profit in the real estate investments , quickly refinance at more favorable terms and have cheap and fine self-owned housing. Banks and financial institution sold the subprime mortgage to investment banks through financial innovation. Then, these investment banks issued large amounts of debt called mortgage-backed securities (MBS), and enabled financial institutions and investors around the world to invest in the U.S. housing market. In the process, these financial institutions also sold risks to worldwide investors. The magic show seemed to be successful, because lower interest rate, zero first payment, and lots of investment demand had led to a huge virtual demand that had real purchasing power in American housing market. Finally, it resulted in sustaining rising of house estate prices.

Marx pointed out that the accumulation of capital in Securitization is the accumulation of virtual capital in reality. “People called the formation of virtual capital capitalizing. They calculate the income earned regularly and repeatedly on average interest rate, and take it as capital gains lent out on former interest rate. In this way, the income is capitalizing.” The lower interest rate is, the bigger capital scale of Securitization is, the higher the price of capital of Securitization is , and bigger the size of virtual capital accumulation is. As real estate has periodical rent income like securities, the scale of investment is very much influenced by interest rate and real estate price. So, there will be huge virtual capital produced in the process of house price rising excessively.

Accumulation of virtual capital is far outweighing the accumulation of real capital. The former proceeds from investment opportunities for real estate and securities price rising. For instance, If the price of real estate is soaring according to expectation, speculative capital is immediately magnetized in house market ,and the market demand will

1 Karl Marx. *Das Capital*. Peking: People Press. Vol 3: 210, 1975.

2 Karl Marx. *Das Capital*. Peking: People Press. Vol 3:212-213, 1975.

increase rapidly too. The real estate is very different from other products. Because its supply is difficult to increase fleetly in short time, so speculations will bring on price soaring up continuously, and periodic rent and comparatively lower interest rate will result in the huge accumulation of virtual capital in real estate market. In 2001, American economy was turning down. For the sake of saving American economy, the Fed cut the interest rates 13 times continuously, the benchmark rate declined to 1 percent. Low interest rates fueled an asset price boom. Between 2003 and 2006, the price of the typical American house increased by 50%. Low interest rate, rising house price, subprime mortgage with zero first payment, together with the MBS stimulates the speculation considerable in real estate market. Marx called virtual capital as nominal money capital, and compared it as a soap bubble. So, there is a huge real estate bubble formed in accumulation of quick accumulation of virtual capital in American real estate market.

But the bubble can't blow up indefinitely. American economy showed a strong indication of economic recovery as of June 2004. The Fed had raised its benchmark rates from 1% to 7.47% from a sense of worrying about inflation and asset price bubble during 2 years. March in 2007, the housing prices started to drop moderately in many parts of the U.S. Refinancing became more difficult, once house prices began to decline. Borrowers who found themselves unable to escape higher monthly payments by refinancing began to default. As more borrowers stopped paying their mortgage payments, foreclosures and the supply of homes for sale increased. Subprime mortgages crisis broke out across-the-board. On the face of it, the outbreak of subprime mortgage crisis was caused by interest rates rising and housing price decreasing. In effect, the virtual demand that had enormous payment capacity for American real estate market was far beyond their real demand that had normal ability to pay for it. The Law of value in real economy was in action independent of man's will. Because the real demand for American domestic real estate can not afford the rising price of real estate bubble, it burst the huge bubble finally. The price of real estate began to come down soon. It was not only toward the value, but also fall below its value for the over-supply in real estate market induced by previous increasing price.

American homeowners with subprime mortgages who are low-income groups paid for this crisis firstly. Most of them lost their houses, ran through their deposits, and sold out their family fortune. Makoto Itoh, the member of World Association of Political Economy and a professor emeritus of the University of Tokyo, pointed out that the financial crisis in 2008 was same as Japanese crisis of the Year. In Japan, Speculative transactions forced up the residential property prices, and induced workers to apply for loans. It caused great damage eventually. The offensive sale promotion for home financing became only good modern means of exploitation invented by all kinds of financial institutions.<sup>1</sup> In the next place, the crisis cut into the public profits. The public suffered the loss of fortune through

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1 China Education Newspaper. 10/14/2008.

depreciation of subprime mortgage bonds and recession of global economy caused by crisis. Marx pointed out that a country won't be exposed to the damage due to burst of nominal capital bubble "when the depreciation don't mean stagnation of production , railway transportation and canal transportation, don't mean the shutdown of enterprises in operation, and don't mean waste of capital on enterprises of no worth"<sup>1</sup>But, economic crisis is an accompaniment of economic bubble burst. The burst of bubble will aggravate economic crisis. It is relating to the sharp reduction of virtual capital, deterioration of credit crisis, heavy loss of fortune bondholders held , and decline of real demand.<sup>2</sup> This financial crisis verified these results with no doubt.

## **II The Roots of financial Crisis: Radical contravention of capitalist mode of production**

Why American government created such a huge virtual demand through subprime mortgage? The root cause of it is distribution System lead to poverty gap makes lots of low-income people lack of enough purchasing power.

Capitalism is a society dominated by powerful capital. In this society, "capital makes products cheaper through improving labor productivity, and makes labor costs cheaper through reduction the cost of production. This is a built-in incentive and a regular tendency."<sup>3</sup> "The reason for improving labor productivity is to shorten the necessary labor time that workers labor for themselves. In this way, it lengthens another part of labor time that workers labor for capitalist"<sup>4</sup> "The price of labour power would decrease continuously when labor productivity was improving. At the same time, workers can get more abundant means of maintenance." But relatively the value of labor would continue to fall compared to surplus value. Consequently, the living gap between workers and capitalists is widening. <sup>5</sup>So, all of the profits improving labor productivity is owned by capitalist in capitalist production relations, and most of values from economic growth belongs to the minority of capital owners as well. To accompany with economic growth, widening disparities between the haves and have-nots are more serious. Statistics show that the fortune of 1% and 1‰ richest man in America hit a record high in 2005 since 1928. The population of the richest is just only 0.3million. Their income equals to the 150million poorest's (approximately 50% of the poorest). From 1980 to 2005, The share of 1‰ richest man's earnings in national income has doubled.<sup>6</sup>

1 Karl Marx. Das Capital. Peking: People Press. Vol 3: 531, 1975.

2 Karl Marx. Das Capital. Peking: People Press. Vol 3: 558-559, 1975.

3 Karl Marx. Das Capital. Peking: People Press. Vol 1: 355, 1975.

4 Karl Marx. Das Capital. Peking: People Press. Vol 1: 537, 1975.

5 Karl Marx. Das Capital. Peking: People Press. Vol 1: 571, 1975.

6 China Education Newspaper. 10/14/2008.

The problem polarization engendered is that “the maintenance and increase of capital value on the basis of deprivation and pauperization of laborers will be in action within limits. These limits are incompatible with capitalist reproduction which aims at increasing production illimitably and developing the productive forces unconditionally. The means, unconditional development of social productive forces, are conflict with the limited aim of existing capital’s Value-added continuously.”<sup>1</sup> One the one hand, capital was collected by promotion of competition and Credit system. The convergence of capital accelerated improvement of the degree of production socialization. As a result, production scale enlarged, and social wealth increased increasingly. On the other hand, distribution relations determined by capitalist production relations limited scale-up of the workers’ demand. “Workers’ ability of consumption was restricted by the law of wages. It restricted by other facts simultaneity, which was workers’ employment which would be realized only if they can produce and bring profits for capital. The radical causes of all crises were poverty of workers and their limited consumption.....”<sup>2</sup> During the period of prosperity, surplus value and capital accumulation stimulated by it increased more, and Latent crisis wouldn’t break out until the production expanded faster than the social purchasing power.

In America, a great quantity of the low-income is short of purchasing power that has payment capacity because of polarization. But it is impossible to avoid economy recession through elimination of polarization by changing its distribution System. The subprime mortgage with zero first payment produced a expansion effect on demand by dint of creating a huge virtual demand. It only delayed the economy recession. The huge virtual demand and the sale of mortgage-backed securities (MBS) enabled large numbers of investors around the world to invest in the U.S. housing market. This accelerated the surplus of supply in relation to the limited real purchasing power in America, and precipitated an worldwide economic crisis by deepening it. So, contravention between overproduction and limited demand of labors determined by the radical contravention of capitalist mode of production, the contravention between large-scale socialized production and capitalist private ownership is the root cause of this international financial crisis.

### **III The roll booster of driving the financial crisis: Neoliberalism**

Keynes suggest that economic fluctuations are caused by many factors, but “Why business cycle can be called a circulation, especially its regulation in order and length of time, is attributed to the change of capital marginal efficiency.”<sup>3</sup> Namely, fluctuation of investment is the root of the periodic fluctuations of economy. “There’s no way to avoid violent fluctuation of employment in the case of Laze fare, unless investors’ psychology

1 Karl Marx. Das Capital. Peking: People Press. Vol 3: 279, 1975.

2 Karl Marx. Das Capital. Peking: People Press. Vol 3: 548, 1975.

3 John Maynard Keynes. The General Theory of Employment, Interest and Money. Shanghai: The Commercial Press, 1977:267.

is changed radically. But it can unreasonably be expected that there will be such a radical change happened. So, I concluded that we can not put the private in charge of the determination of investment.”<sup>1</sup> Thus it will certainly result in economic recession in the Laze-fare economy, and the government will have to take a hand in regulating the macroeconomic operation consciously, especially a reasonable regulation in investment. When Keynesianism dominated the economic research and their regulatory policies between 1945 and 1973, it greatly affected the financial business and system at that time. Most of capitalist countries imposed strict controls over the economic and financial system universally.

From Classic Economics to the Neoclassic Economics and Neoliberalism, economists have affirmed that market is the only valid regulator of economic activities. They argued against the intentionally government interventions and regulation on macroeconomic operation. Based on inheriting the economic theory of Classical liberalism, Neoliberalism beginning in the 1960's that characterized by anti-Keynesianism and advocating liberalization considered free as the prerequisite of efficiency. Advocating Privatization that is universally acknowledged private ownership is the basis for economic development. Advocating marketization that is generally believed there is no economic development and efficient allocation of resource without market. It also opposed the government intervention.<sup>2</sup> Since 100 years ago, Marx have pointed that “free market economy is premise with means of production held by different and independent producers.....they only admits the power of competition without consideration of others.....”<sup>3</sup> “The Bourgeoisie.....scolds any consciously social supervision and adjustments for the process of social production.they describe them as the private property infringement which is not allowed and free and self-determined originality.”<sup>4</sup> It is obvious that Neoliberalism doesn't surpass the classicism and the anarchism affirmed by the Bourgeoisie in the age of Marx. Since 1980s, Neoliberalism have gradually taken the place of the Keynesianism .Government in capitalistic countries believed in free market economy and released control of economy and finance. At present, the Flower of Neoliberalism advocated by capitalistic world is beginning to boom what is the international financial crisis.

David Kotz who is an American economist pointed out that “financial crisis would be frequent under the Neoliberalism condition through the history of American modern economic development. America pursued comparative free market economy in 19 century, and there would be a financial crisis happened seriously once in 10 years at that time. Free market economy lead to the collapse of American financial system as to 1929. Hereafter,

1 John Maynard Keynes. *The General Theory of Employment, Interest and Money*. Shanghai: The Commercial Press. 1977:272.

2 See two papers about study on Neoliberalism. *XinHua Digest*, No.5, 2004.

3 Karl Marx. *Das Capital*. Peking: People Press. Vol 1: 393-394, 1975.

4 Karl Marx. *Das Capital*. Peking: People Press. Vol 1: 395, 1975.

American government had pursued a regulated capitalism between 1945 to 1973, and there was no a big financial crisis happened and a big financial institution becoming impoverished .But since 1980, American economy produced a series of asset bubbles along with the rise of Neoliberalism, and gave birth to many corresponding financial problems. For example, a bigger economic crisis took place in America in 1980s , and Savings bank, a kind of special financial institutions, was broke. As an aftermath of it, government had to spend hundreds of billions of dollars in saving theses banks. In 1990s, there was another huge bubble produced in American stock market that attracted worldwide investments in it. This bubble burst in 2000, and left over hundreds of billions of dollars in damage. Since the 20th century, American house market have emerged a huge bubble too, and it have been breaking for the moment”<sup>1</sup>. This is because regulated capitalism relieved the contradiction between production and consumption determined by the basic contradictions of capitalism through strict regulation of economy and financial system ,taxes for adjusting the gap between rich and poor, and practice of the Social Welfare System. But the Views of Neoliberalism did exactly the opposite. They argue against conscious regulation and adjustments to market form society. Free regulation through the market will aggravate contradiction between production and consumption and deteriorate the crisis in contemporary society that characterized by rapid improvement of socialization of production and fast advancement of world economic integration.

An intensive study about cyclical economic crisis happened in the condition of *laissez-faire* and competitive capitalism by Marx showed that market failure is a booster for break- out of economic crisis in a capitalist economy marked by free competition.

First, free competitive market economy in capitalism aims at maximizing profits. Persistent capital accumulation and reproduction on extended scale are important ways for realizing profits maximization. The contradiction between unlimited expanding of production and relatively inadequate consumption demand became ever more aggravated continually in the process of persistent capital accumulation. This contradiction can only be solved through the break-out of economic crisis in market economy which is in anarchy. Periodic break-out of economic crisis is a sign of noneffective for adjusting economy by capitalist free competitive market. “social sense always takes effect when a thing is done, so it is possible and certain to produce tremendous turbulence continually.”<sup>2</sup>

Secondly, free competitive credit system of capitalism is a powerful lever of capital centralization, and it supports the real economy with credit funds. This will produce virtual social demand to stimulate expansion of production in the real economy whose departments were often restricted by capital, especially which had long cycle in production. But “the restriction was removed by credit system and associated joint venture, Such as joint-stock

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1 China Education Newspaper. 10/14/2008.

2 Karl Marx. *Das Capital*. Peking: People Press. Vol 2: 350, 1975.

company. So, the confusion of money market would endanger these kinds of companies, and they will cause chaos in the money market accordingly. ”<sup>1</sup>The features of this international financial crisis included that subprime mortgage and financial innovation without supervision created the virtual demand with payment capacity for American housing market, the free competitive credit system in capitalism drove the unbalance between supply and demand in real economy, and occurrence of the real economic problems caused chaos in money market too. Therefore, this financial crisis is economy crisis in essential, and subprime mortgage and financial innovation without supervision were boosters of the crisis.

The analysis on the causes for this international financial crisis showed that governments should deal with it by acting together in harmony. All the measures what governments adopt should aim at controlling and resolving the crisis. For the future, it is necessary to design the financial innovation scientifically and rational, and take measures to adjust, supervise and regulate the market economy, which includes financial system, industrial structure, and structure of income distribution. It is the basic guarantee for avoiding the persistent great turbulence produced in capitalism. It is also the necessary adjustment for relations of production to adapt the improving of socialization production in capitalism, and it is a result of social evolution from the primitive to the advanced.

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