PRODUCTION AND FINANCE

In a review of a new book on the problems of the U.S. economy,* Cornell economics professor Alfred E. Kahn, perhaps best known as Jimmy Carter's "inflation fighter," articulates in the briefest and clearest form an important tenet of orthodox economics which is usually taken for granted and left unexpressed. He writes:

> Contrary to popular assumption, speculation in securities, real estate, and commodities, and mergers and acquisitions of existing companies do not waste capital that would otherwise be used for productive investment. All they do is transfer dollars from purchasers to sellers. The authors clearly imply that if these funds had gone instead into new plant and equipment, the result would have been a far more satisfactory rate of economic growth. This is economic nonsense. According to that reasoning, the $66 billion used to purchase stocks in the New York stock exchange this past October alone could instead have more than tripled our acquisition of new plant and equipment! But of course that would have been physically impossible. The point is that these mere purchases and sales of existing assets do not use up real resources (except for the time put into making the transactions). (*New York Times*, Sunday Book Review section, December 12, 1982)

Is this true or isn't it? The answer is that some of it is, some of it isn't, and the conclusion to which it leads is false. By reformulating the statement with a few changes and amendments, we reach the opposite conclusion:

* Barry Bluestone and Bennett Harrison, *The Deindustrialization of America: Plant Closings, Community Abandonment, and the Dismantling of Basic Industry* (New York: Basic Books, 1982).

In accordance with popular assumption, speculation in securities, real estate, and commodities, and mergers and acquisitions of existing companies absorb money capital that could otherwise be used for productive investment. Instead of being transferred from purchasers to sellers, they could have gone into buying new plant and equipment, and the result would have been a far more satisfactory rate of economic growth. This is economic common sense. According to that reasoning, the $66 billion used to purchase stocks on the New York stock exchange this past October could have greatly increased our acquisition of new business plant and equipment. With more than 10 percent of the labor force unemployed and more than 30 percent of productive capacity idle, that would have been physically perfectly possible. The point is that purchases and sales of existing assets, while not using up real resources (except for the time put into making the transactions) do provide uses for money capital that otherwise could have been transformed into real capital.

What would (or could) orthodox economists say to this? We're not sure, since they rarely if ever pose the problem in this way. For them money used to buy existing assets is not capital; it is simply a means of circulation which does not impinge on the productive process. This is in keeping with a very old way of looking at the economy, i.e., dividing it into two realms, the "real" and the "monetary," with the latter being treated as a veil which hides the real economic processes. If it can be shown that certain activities pertain only to the monetary realm (like the purchase and sale of existing assets), they can be ruled out as having any influence on the real realm.

The trouble with this approach is that there is in fact no separation between the real and the monetary: in a developed capitalist economy practically all transactions are expressed in monetary terms and require the mediation of actual amounts of (cash or credit) money. Some of these transactions are generated in the process of production (payment of wages, distribution of incomes derived from profits, purchase of means of production and consumer goods) and some are generated by financial transactions (borrowing and lending, purchase and sale of existing assets, etc.). The appropriate analytical separation here is not between real and monetary (all are both real *and* monetary) but between productive and financial. One can thus legitimately distinguish between the underlying productive base of the economy and its financial superstructure (not to be confused of course with the base/superstructure metaphor commonly used in expounding the theory of historical materialism).

In the earlier days of capitalism—roughly prior to the Civil War in the United States—when most production was carried on by small competitive proprietorships or partnerships, the financial superstructure was relatively insignificant and for analytical purposes could be ignored. In those days economists developed the real/monetary distinction as a method of contrasting the way the actual economy functioned and the way a hypothetical barter (moneyless) economy presumably would function. Money was thought of as having been imposed on a natural barter economy, becoming in the process the source of a wide variety of price (as distinct from value) phenomena like inflation, gluts, panics, and later the business cycle.

By the end of the nineteenth century, with the spread of larger and larger corporations as the typical form of business enterprise, the composition of the capitalist economy underwent a qualitative transformation. The issuance of many types and quantities of corporate securities brought in its train the development of organized stock and bond markets, brokerage houses, new forms of banking, and a community of what Veblen called captains of finance who soon rose to the top of the capitalist hierarchy of wealth and power.

In the twentieth century the growth of the financial sector has proceeded apace, both absolutely and relative to the underlying productive sector, most especially in the long post-Second World War boom during which there has occurred a veritable explosion of new kinds of financial institutions and instruments along with speculative activity on an unprecedented scale.

For reasons which need not detain us—and indeed which have never been seriously studied—orthodox economics paid scant attention to this continuing transformation of capitalist economies. To be sure, the rise of large-scale production units was given belated recognition (in the 1930s) in new theories of imperfect or monopolistic competition, but these were focused on individual firms or industries and no attempt was made to extend them to take in the whole economy. Moreover, developments in the field of corporate finance and banking were relegated to the status of "applied economics" having at best a loose and ill-defined relation to the hard core of economic theory (the "neoclassical synthesis") which, apart from a variety of lovingly elaborated refinements, remained pretty much what it had become when Alfred Marshall published the first edition of his *Principles of Economics* in 1890. It is true that the work of Keynes (*A Treatise on Money*, 1930; and *The General Theory of Employment, Interest and Money*, 1936) constituted a partial exception to these generalizations. There is no sign of the real/monetary dichotomy in Keynes, and there are places where he clearly recognizes the distinction between productive and financial sectors (especially in Chapter 15 of *A Treatise on Money* entitled "The Industrial Circulation and the Financial Circulation"). Still, Keynes did not follow up his own leads and never got around to conceptualizing the economy as a whole in terms of the two sectors as a preliminary to exploring their interactions historically as well as analytically. And in this respect, as well as in others, the subsequent development of mainstream economics has been a retreat from the advances pioneered by Keynes in the 1930s.

What has to be understood—and what is missing from the kind of reasoning exemplified by the statement of Alfred Kahn quoted above—is that in modern complex economies, a large and growing part of money capital (i.e., money invested with a view to earning more money) is not directly transformed into productive capital serving as the means by which surplus value is extracted from the productive utilization of labor power. Instead it is used to buy interest-bearing or dividend-yielding financial instruments. It used to be an axiom of orthodox theory that the sellers of these instruments (stocks and bonds) were themselves productive capitalists who would use the proceeds to expand their real capital, handing over to the buyers part of their increased surplus value in the form of interest and dividends. To the extent that this is what actually happens, the money capitalist simply becomes a kind of partner of the productive capitalist.

Nowadays, however, this is very far from what actually happens. Money capitalists are being offered an enormous variety of financial instruments to choose from—stocks and bonds, certificates of deposit, money-market funds, titles to all sorts of assets, options to buy and sell, futures contracts, and so on. There is no presumption, let alone assurance, that money invested in any of these instruments will find its way, directly or indirectly, into real capital formation. It may just as well remain in the form of money capital circulating around in the financial sector, fueling the growth of financial markets which increasingly take on a life of their own.*

In the present state of knowledge it is not possible to define or delineate the financial sector with any accuracy, and perhaps it never will be.** But that it is large and getting larger both absolutely and relatively is clear to any reasonably attentive observer of the economic scene. And these observations can be supported in a general way by readily available statistical data. For example:

- According to data cited by Guy E. Noyes, former vice president and chief economist for Morgan-Guaranty Trust Company (*Morgan-Guaranty Survey,* October 1981), at the end of 1980 debits to demand deposits (i.e., checks written against demand deposits) were running at an annual rate of approximately $68 trillion compared to a Gross National Product of $2.7 trillion. Thus only some 4 percent of payments by check were related to transactions involving the goods and services that compose GNP. "A large volume of transactions, not

---

* The Marxian formula for the productive investment process is M-C-M[1]—money exchanged for commodities (means of production plus labor power) which are used to produce more valuable commodities which in turn are sold for more money than was originally laid out. The corresponding formula for money capital is M-M[1], i.e., money which yields more money without the intervention of a process of production. Marx aptly referred to this as capital in its "most externalized and fetish-like form." (*Capital,* vol. 3, Kerr ed., p. 459)

** The difficulty stems in large part from the fact that most of the large corporations which are officially classified as "nonfinancial" are in reality, at least to some extent and often to a substantial extent, engaged in financial operations such as buying and selling securities and other existing assets, borrowing and lending money, etc. They take in large amounts of money (from both productive and financial operations) over and above what they distribute to their stockholders and creditors. In deciding how to invest these funds, they are guided by criteria of profitability, safety, liquidity, etc., which often means that they invest in financial rather than productive assets. They are, in other words, money capitalists as well as productive capitalists.

counted in the 4 percent figure," Noyes explains, "involves intermediate purchases of goods and services—as opposed to final purchases, which is what GNP measures. However, financial payments represent far and away the great bulk of total debits to demand deposits." This does not mean that most of the nation's money is tied up in the financial sector, but it does mean that most of the economy's money *flow* (quantity of money times average number of turnovers in a given unit of time) takes place in the financial sector. Since the rate of turnover is very high in the financial sector, less money is needed to sustain a higher flow of payments. Still, the financial sector does absorb a vast amount of money. It follows of course that any change in the relative profitability of production and finance can quickly send money scurrying from one sector to the other with significant consequences for the way the system functions.

- In 1950 dividends and interest amounted to 8.1 percent of total personal income. By 1982 this had increased to 17.1 percent, a gain of over 110 percent. (*Economic Report of the President,* 1983, pp. 188-89) A major reason for the growth of interest and dividends has been the dramatic rise in interest rates. But that is itself a product of the ballooning financial superstructure which stretches credit to an extreme limit and even beyond the bounds of rational finance.

- Pretax profits of financial corporations averaged 10.9 percent of total corporate profits in 1945-54. This had risen to 15.7 percent by 1975-81, an increase of 44 percent. (*The National Income and Product Accounts of the United States, 1929-76,* pp. 283-84 and *Survey of Current Business,* July 1982, p. 92) The increase in the share of finance would certainly have been greater if it were possible to separate out and count the financial operations of what are officially classified as nonfinancial corporations.

- Employment in "Finance, Insurance and Real Estate" increased from 3.6 million in 1970 to 5.4 million in 1982, a rise of 50 percent. This compares with an increase in total employment in the same period of 26 percent. In other words, in terms of employment the financial sector grew almost twice as fast as the economy as a whole. (*Economic Report of the President,* 1983, p. 205)

The foregoing are evidently no more than indicators or symptoms of long-term trends at work in the U.S. economy; in and of themselves they do not tell us anything about the consequences of the shift away from production and toward finance for the overall functioning of the system. For this we must inquire into the way the two sectors—production and finance—interact with each other.

We have found that the most useful way of pursuing this inquiry focuses on the production and utilization of society's surplus product under conditions of monopoly capitalism. The basic condition for any society's survival and reproduction is the uninterrupted operation of a productive sector which supplies the consumer goods required by the population, plus the producer goods to replace what wears out and (if conditions are favorable) to add to the productive base. In primitive societies there is normally little left over after the people's livelihood has been provided for, so growth is at best slow and often nonexistent. As civilization progresses, labor becomes more productive, the surplus (over and above what is required to maintain the working population) grows, new classes of non-workers emerge (landlords, priests, government functionaries), and faster growth becomes possible. Still, throughout most of human history the surplus remained small and was from time to time reduced or even wiped out in the face of adverse natural conditions, wars, plagues, etc. This is why history seems to move so slowly for so long and why apparently flourishing civilizations decline and fall.

The arrival of capitalism introduces a new dynamic element into the historical process. The rate of increase of labor productivity quickens. As Marx and Engels put it in *The Communist Manifesto,* the "bourgeoisie . . . has created more massive and more colossal productive forces than have all preceding generations together." The surplus product grows by leaps and bounds. During most of the nineteenth century in the countries of advanced capitalism a large part of this growing surplus was plowed back into expanding the productive base, and much of the rest went into nourishing the growth in the numbers and standard of living of the non-working classes. In time, however, these traditional ways of utilizing the surplus proved increasingly inadequate to keep the capitalist machine running at or near full capacity. New science-based technologies and improved forms of organizing the labor process proved to be, in one of Veblen's favorite phrases, "inordinately" productive. One result was, as Veblen noted in a path-breaking study as early as 1904, that the economy tended to slow down and to operate for sustained periods at less than full capacity.* One remedy for this situation, Veblen argued, could be sought "in an increased unproductive consumption of goods," but he was not optimistic about its effectiveness:

> Wasteful expenditure on a scale adequate to offset the surplus productivity of modern industry is nearly out of the question. Private initiative cannot carry the waste of goods and services to nearly the point required by the business situation. Private waste is no doubt large, but business principles, leading to saving and shrewd investment, are too ingrained in the habits of modern men to admit an effective retardation of the rate of saving. Something more to the point can be done, and indeed is being done, by the civilized governments in the way of effectual waste. Armaments, public edifices, courtly and diplomatic establishments, and the like are almost altogether wasteful, so far as bears on the present question. They have the additional advantage that the public securities which represent this waste serve as attractive investment securities for private savings, at the same time that... the savings so invested are purely fictitious savings and therefore do not act to lower profits or prices.... But however extraordinary this public waste of substance latterly has been, it is apparently altogether inadequate to offset the surplus productivity of the machine industry, particularly when this productivity is seconded by the great facility which the modern business organization affords for the accumulation of savings in relatively few hands. (*Ibid.*, pp. 255-57)

Veblen might have gone on to cite the growth of the financial sector, of which he was one of the earliest and most insightful observers, as an additional offset to the "surplus productivity of modern industry." The reason he didn't is probably that at the time he was writing *The Theory of Business Enterprise* in the

* "It might even be a tenable generalization... to say that for a couple of decades past the normal condition of industrial business has been a mild but chronic state of depression.... Seasons of easy times, 'ordinary prosperity,' during this period are pretty uniformly traceable to specific causes extraneous to the process of industrial business proper." (*The Theory of Business Enterprise*, pp. 184, 251).

first years of the present century the financial sector, in a purely quantitative sense, was still quite small. It is interesting to note that Baran and Sweezy, in *Monopoly Capital* (1966), also failed to focus on finance, along with the sales effort and government spending, as a major absorber of surplus, although they had much less reason than Veblen for the oversight. Be that as it may, there is certainly no excuse for continuing to ignore this role of finance after the fantastic explosion of the financial sector which characterized the 1960s and 1970s.

If a capitalist economy worked in the manner assumed by the textbook models, there would be no reason for the development of a distinct financial sector. All incomes would be paid out by productive enterprises in the form of wages, salaries, dividends, interest, and rent; and all incomes would be spent on consumer goods or on means of production serving to expand the productive base of the economy. Savings would be directly invested in or loaned at interest to productive enterprises, and credit would be limited to the modest role of facilitating commercial transactions and economizing on the need for cash.

With the coming of corporations all this gradually changed. The original purpose of the corporate form was to allow a number of investors to go into an enterprise together without each of them running the risk of losing his or her entire fortune. The matter is often presented as though this is really only an extended partnership with each participant actually owning a piece of the productive assets in question. But this is not so. The corporation itself owns the real assets, and the participants own only shares in the corporation—pieces of paper embodying specified legal rights (to vote for directors, receive dividends when declared, acquire a pro rata share of assets in case the corporation is liquidated, etc.). The difference between owning real assets and owning a bundle of legal rights may at first sight seem unimportant, but this is emphatically not the case. It is in fact the root of the division of the economy into productive and financial sectors.

Corporations can of course sell their assets, wholly or in part. Shareholders on the other hand can only sell their pieces of paper. In the absence of an organized market, this is not easy, as many early corporate shareowners discovered. But even before the rise of the corporation, organized securities markets existed, most notably those handling government bonds and to a lesser extent the shares of banks and insurance companies. As the volume of new corporate securities swelled in the closing decades of the nineteenth century, the established dealers and brokers—a good example was J. P. Morgan who got his start as a financier to the Northern government during the Civil War—were more than anxious to extend their activities to include these new types of securities.

It was in this fashion that corporate securities acquired the attribute of liquidity—instant convertibility into cash—which the physical assets of corporations by their very nature could never have. And once this stage had been reached, the way was open for a proliferation of financial instruments and markets which, so far at any rate, has proved to be literally unlimited. A crucial step in this development was the determination by state legislatures and the courts that corporations had the power not only to issue their own securities but also to own the securities of other corporations. Thus was born the holding company, a corporation whose purpose is to own the securities of other companies. Given this possibility, corporations could be piled on top of other corporations in a theoretically endless chain, with the aggregate number and volume of corporate securities growing in step and without any addition to the underlying productive base at the bottom of the pyramid.

This is not the place to detail the various other ways in which the financial sector, once established on a solid independent basis, expanded its size and its influence. Buying and selling securities on credit, the development of options and futures markets, the multiplication of specialized financial intermediaries, orchestration of corporate mergers and acquisitions—all these and more have been part of the build-up which has resulted in the huge financial sector which looms so large on the present-day economic scene.

What, then, is the nature of the interrelation between the productive and the financial sectors? Clearly the financial sector does not itself produce anything with significant use value. On the other hand it does use up a lot of real resources: the nearly 5.4 million employed in this sector (see p. 6 above) presumably consume on the average as much as (and perhaps even more than) employees in the rest of the economy; banks seem to need fancier buildings than most businesses; a very substantial part of the output of the hi-tech industries (computers, communication equipment, etc.) certainly goes to the financial sector. In Veblen's terminology quoted above, the financial sector evidently does its part to offset the surplus productivity of modern industry. Nor is the demand which it directly generates for consumer goods and means of production the full extent of its contribution in this respect. Recent years, and even more dramatically the last nine months, have shown that the financial sector can prosper while the productive sector continues to stagnate.* When this happens, the favorable impact of the financial sector on the productive sector is not limited to the increased demand for the latter's products created by more employment and greater profits in the financial sector. There is also the indirect effect of an increase in the value of financial assets held by households and businesses throughout the economy. The *Morgan-Guaranty Survey* for March estimates that "the value of consumer-held stocks, bonds, and liquid assets rose more than $500 billion in the last half of 1982," obviously wholly a result of activity in the financial sector. This should have some stimulating effect on consumer demand, though in the present overall condition of the economy this may show up more in slowing a decline than in registering an increase.

What about the outlook for the period ahead? Can this seemingly contradictory coexistence of a prosperous and expanding financial sector and a stagnant production sector continue? It is probably safe to say that in the long run the answer is no. But this doesn't help much since no one can define the long run, and in the meantime capitalist enterprises are for the most part constrained, whether they like it or not, to make decisions on the basis of the immediate outlook.

In the productive sector, with demand stagnant and nearly a third of productive capacity lying idle, this means trimming

* Between August 1982 and the end of February this year the New York Stock Exchange composite index went up 35.7 percent, while industrial production and profits of nonfinancial corporations were both declining.

costs of production (especially by firing workers and cutting wages) and limiting investment to unavoidable maintenance and replacement—a perfect recipe for perpetuating stagnation. In the financial sector things are different. There is plenty of money available (cash plus unused credit), and hunger for profits added to competitive pressures drives all financial enterprises to put as much of it as possible to work. This generates an upward tendency in the price of financial instruments which in turn sparks a speculative psychology which comes to pervade the financial community and to provide its own justification.

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

No assured answer can be given to these questions. But we are inclined to the view that in the present phase of the history of capitalism—barring a by no means improbable shock like the breakdown of the international monetary and banking system—the coexistence of stagnation in the productive sector and inflation in the financial sector can continue for a long time. The reason is that the underlying attitudes of the capitalist class, especially in the United States, are dominated by a set of expectations deeply rooted in the history of the capitalist system. Capitalist ideology takes for granted that the *normal* state of the economy is prosperity based on vigorous growth. Deviations from this norm—so the argument goes—are temporary and bound to be reversed. This holds not only for the recessions/depressions of the ordinary business cycle but also for the longer periods of stagnation which are supposed to come along every 50 years or so (hence the growing popularity in the business press of theories of the so-called long-wave cycle). We are in such a period now, according to this view, and it is due to last pretty much through the 1980s and to be followed by a new long upswing in the 1990s and after.

As long as capitalists really believe this (or something similar)—and we think there is no doubt that they do—it provides a reasonable explanation for the kinds of behavior which characterize the productive and financial capitalists respectively. Those who are entrenched in the productive sector can only batten down the hatches (mostly at the expense of labor) and wait for the new long-term upswing to begin. Those who operate in the financial sector on the other hand can rationally (so it seems to them) value their pieces of paper at what they presumably will be worth after the upswing gets under way. Hence stagnation in the productive sector and inflation in the financial sector.

As MR readers know, we regard the 50-year cycle as ideology in the bad sense of the term, i.e., a myth which serves to rationalize capitalist interests. The norm of mature capitalism is stagnation, not vigorous growth. In the absence of powerful extraneous stimuli, of which there are no present signs anywhere on the horizon, the stagnation drags on and, except for occasional zigs and zags, feeds on itself. If this is a correct diagnosis, the U.S. capitalist class, like the rest of the American people, is in for a rude awakening some time down the road. But whether this will occur in the "natural" course of events, or whether a severe shock such as might be administered by an international financial panic will intervene and set events on a new course—these are questions to which no sensible answers can be given in advance. In the meanwhile we must not be surprised if the strange *pas de deux* being enacted these days by the productive and financial sectors continues for a considerable time yet.

(April 6, 1983)

How can we call those systems just
Which bid the few, the proud, the first,
    Possess all earthly good;
While millions robbed of all that's dear
In silence shed the ceaseless tear,
And leeches suck their blood?

—Philip Freneau