The Birth of International Surplus Capital and After*

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Abstract

The paper presents the basic conceptual framework, whereby to comprehend a series of global financial crises since the early 1980s, i.e. absolute, relative, and absolute and relative surplus capital on the global scale. A short history of the birth of international surplus capital in the middle of the 1990s is followed by the author's interpretation of the present global financial crisis beginning with subprime mortgage crisis in 2007. And finally, merits and advantages of dialectical conceptual analysis are advocated as an economic methodology.

Key words: international surplus capital, a financial crisis, speculation, over-accumulation, subprime mortgage loan, the perfect-markets hypothesis, conceptual analysis, and dialectics

JEL Classification: B41, B51, F21, G15, N20

1 Introduction

The author published in 2006, *The Birth of International Surplus Capital* (*Kokusai Kajo Shihon no Tanjo*, in Japanese). It is a record of my academic pursuit for decades of establishing a very special and classical concept of "surplus capital", in which I attempted to understand global financial crises with the help of the new concept "international surplus capital". Its analytical results can be simply summarized in a sentence: i.e. the most developed form of international surplus capital was born in the middle of the 1990s. It challenged to expose the secret of birth, as it were, of the fundamental driving force of global financial crises, excluding the present one that started in 2007, despite somewhat apocalyptic words about it in the preface of the book.

The objective of the paper is to summarize the basic framework of analysis I adopted to comprehend the fundamental transformation of the global economy that started in the early 1980s under the new politico-

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economic system, i.e. the neo-liberalism.

The concept, *surplus capital*, I heavily relied on in the book sounds rather classical or even old-fashioned to ears of modern economists. And the method I used looks quite descriptive without the mathematical straight jacket of model building, although the book devoted almost all chapters to comprehensive statistical analysis. Readers of this paper will find that the author attempts to carry out an experiment of what he calls conceptual analysis. Firstly in section 2, the exact definition of international surplus capital will be given, and secondly in section 3, a short history of international surplus capital will be given until the middle of the 1990s. Analytical validity and robustness of surplus capital will be tested in section 4 by its explanatory power about the current financial crisis. And I make a methodological contrast in the last section 5 between mathematical model analysis and dialectical conceptual analysis, and emphasize latter's advantage as an analytical tool when we deal with long-term historical phenomena.

2 Some Basic Concepts regarding International Surplus Capital

The concept of capital is defined, in its most abstract manner, to be economic value that endlessly repeats its self-propagation processes on the basis of capital-labor relations. During the time of an economic recession or depression, however, the processes are firstly stuck with a pile of unsold inventories (i.e. surplus commodity capital), secondly they witness a fall of capacity utilization rate (i.e. surplus production capital) and finally they end with redundant money that cannot transform itself into production capital (i.e. surplus money capital). Capital that exists and develops in these three forms, contrary to its basic definition, is what we call absolute surplus capital.

Relative surplus capital, by contrast, manifests itself in the phenomenon of the long-term declining tendency of the general profit rate, which is due to an increase in the capital equipment ratio, an increase in the fixed capital ratio, an extension of capital turnover period and, in particular, strengthened bargaining power of organized workers. These causes ultimately stem from long-term development of productive power in capitalism through a series of ups and downs of business cycles. Therefore, relative surplus capital can be said to be capital in the state of chronic malfunction in which capital's desire of propagation and accumulation is not fully or properly satisfied. Actually in history, the US and other advanced capitalist countries experienced it from the middle of the 1960s to the early 1980s.

The most important point with respect to surplus capital is that money capital, once created through the process of credit creation, will never have its value destroyed unless banks' deposit money disappears owing to their bankruptcy. Surplus commodity capital, by contrast, will lose its use and exchange value when redundant commodities are disposed, and surplus production capital will be destroyed when unused factories are closed and firms go bankrupt. It thus follows that the disparity in value between partly destroyed production capital and intact money capital results in surplus money capital redundant for the purpose of production. Surplus

money capital will be accumulated sporadically each time when a business cycle goes down, and gradually expand fictitious capital such as stocks, bonds and real estates. Fictitious capital is conceptualized as absolute and relative surplus capital in the sense that it is completely separated from and has nothing to do with direct production processes, and that it gradually deteriorates its profitability over time. In advanced capitalist countries fictitious capital has repeated its booms and busts since the early 1980s when their profit rates hit the bottom and began to sharply recover, and interest rates peaked out and began to decline.

We so far dealt with domestic surplus capital and hereafter define what we call international surplus capital. *International absolute surplus capital* appears particularly among advanced capitalist countries in the phenomenon in which an economic downturn causes private investment in plants and equipments to decrease and thus, trade balance shows the tendency towards surplus and investment balance towards deficit. This reflects domestic surplus of commodity capital and also behind it a decline of capacity utilization rate; and as a result, surplus money capital outflows abroad. If surplus in trade balance continues for a long-term and international investment accumulates, we have *international relative surplus capital*. It will leave the sphere of domestic industrial capital and go abroad, and then transform itself into foreign direct investment, bank loan, securities investment, etc. Finally, as surpluses in trade balance and income balance expand hand in hand, the composition of international investment is likely to change into that which consists more of bond and stock investment: international investment in bonds and stocks thus created is what we call *international absolute and relative surplus capital*.

International surplus capital contains within itself a fundamental contradiction: i.e. as a form of capital, it always demands earnings either in profits, interests or capital gains whenever it conducts endless circuit movements, although as surplus capital, it is separated from and has nothing to do with production processes, i.e. the origin of profits and interests. When you look at international balance of payments of an individual country or countries as a whole, you are certainly surprised to know that the value of gross financial account is many times as large as that of net current account. The huge discrepancy between them represents the value of international surplus capital that is flowing in and out among countries and turning over uselessly for the purpose of creating national income. It is still capital, however, that is destined from its birth to endlessly propagate its value; otherwise it would cease to be capital at all. This is exactly where the contradiction in surplus capital between being capital and being surplus gives rise to a unique feature to it: i.e. speculation in pursuit of capital gains at the expense of other's capital losses, in another word, cannibalism among capital.

3 The Birth of International Surplus Capital

Although, due to the limit of space, we cannot examine statistical data, the historical process of the birth of international surplus capital, so far theoretically conceptualized, is summarized as follows. Until the early 1980s when an international debt crisis broke out among developing countries, the primary form of international

surplus capital had been bank loan that was transformed from domestic surplus capital in advanced capitalist countries. The repeal of convertibility from the US dollar into gold in 1971 and the start of floating foreign exchange rates in 1973 activated a large amount of money capital circulating among banks and thus, created an essential condition of enabling the capital transformation. In the early 1980s, the epoch making period in the world economic history, the dramatic improvement of profit rates finally paved the way to a sharp recovery of stock markets and led to the breathtaking expansion of fictitious capital here and there in the world. Against such domestic circumstances, securitization of international surplus capital began at first with bond investment between advanced capitalist countries. A collapse of US current account balance into deficit in 1983 and the corresponding "twin deficit" detonated the process of securitization. Japan and Germany made their impressive debut in the world financial stage and the UK, successfully carrying out "the Big Bang" in 1986, embarked on the worldwide capital turnover of bonds and stocks via the City as a gigantic axis of international financial markets.

The reunification between East and West Germany gave an indispensable opportunity to Germany and France, so far alienated from international stock investment, to throw them for the first time into the whirlpool of global capital turnover. France in the 1990s was in the state of enormous surplus capital; she took advantage of it and invested massively in German bond markets. The UK transformed into German bonds Japan's bank loan and euro dollar that flew to the City. Germany set aside a small part of the money flown into her bond markets for financing her own "twin deficit" and directed the rest to foreign direct investment and stock investment abroad; then Germany established a circuit of transforming capital into bonds and stocks and circulating them with her Frankfurt markets as a junior axis to the City of London.

In the second half of the 1990s, an economic bubble, which was excessively prompted by central banks' easing policy, broke out in information-technology-related stocks all over the world. International stock investment in both inflow and outflow skyrocketed in advanced capitalist countries except Japan. In the midst of the bubble even foreign direct investment, i.e. industrial capital's investment abroad, turned into a quasi-portfolio investment and indulged in cross-border M&As. Then around the middle of the 1990s stock capital was finally born as the most advanced form of international surplus capital, which massively and freely circulated among developed and developing capitalist countries and countries in transition (i.e. former socialist countries) with the New York Stock Exchange and the City of London as the most important axes of its turnover. And now bond investment of Japan and East Asian countries to the US is the major pillar that supports colossal US current account deficit and serves as the conduit that provides the world with their original surplus capital

4 The Development of International Surplus Capital after the Sub-prime Mortgage Crisis

The argument above is a result of my research so far. Developments of the actual world economy, however, are now surpassing the scope of my examination at an enormous speed. I regarded the establishment of global turnover of stock capital in the middle of the 1990s as "the birth of international surplus capital"; strictly

speaking, though, it should be "the birth of the *components* of international surplus capital". This is because it is exactly in the middle of the 1990s that the markets synchronization began in earnest among various financial products, such as bank deposits, bonds and stocks in addition to primary products, real estates, gold, etc. Securitization and financial derivatives enabled the close linkage and synchronization among them. Securitization is a technique that creates financial products out of any kind of assets on the basis of their cash flows. And derivatives are a means that links together financial products thus created, in space in the case of swaps, in time in the case of futures and between risk hedges and speculations in the case of options.

New types of financial products and investors got into the limelight of global financial markets, which take the best advantage of the techniques of securitization and derivatives and embody linkage and synchronization among financial products. They are structured securities, structured investment vehicles (SIV) and hedge funds among others. Structured securities are financial products that securitize complicated cash flows out of a great number of assets or debts, which are divided into several tranches and thus, enhance overall credit rate. SIVs and hedge funds may be possible to be conceptualized as a further developed form of international surplus capital, i.e. "fund capital", in the sense that they contain and combine a variety of financial products as their components. They are considered to be special forms of existence of international surplus capital that complicatedly combine its individual forms of existence, such as bank loans, bonds, stocks, primary products, real estates and gold. And they are ultimately linked with US treasury securities whose credit guarantee stems from the US government's tax authority; and thus, they are virtually converted into US treasury securities through derivatives. The FRB's open market operations via treasury securities establish the global system of short- and long-term interest rates.

The global hierarchical structure of financial products thus established is proud of its highly sophisticated and efficient linkage and synchronization. It also inevitably incorporates unprecedented dangers that may well give rise to chain reactions of totally unexpected capital destruction and value predation once financial markets get under acute strain. The subprime mortgage crisis, beginning with the closure of a few funds under BNP Paribas in August 2007, was a scary event that vividly showed the new type of international surplus capital might have immeasurably destructive power of devastating the global financial network: a set of springs, so far flexibly linking financial products together, came out of joint one after another and began to synchronize in the utterly opposite direction. Then, the very credibility came into question regarding US treasury securities in the center of the global financial hierarchy, and so did capital impairment of the FRB virtually as the world central bank. And now we understand that the real last resort is not provided by the central bank, but taxpayers who can save the whole financial system with their real money.

What was the driving force that caused such a devastating panic in the global financial markets? People put the blame on greed for money, predatory mortgage loans to unaffordable people, complicated investment scheme such as CDOs and SIVs, lack of proper and comprehensive regulations over commercial and investment banks, excessive savings in China and others that flew into the US, imperfections in the Black-Sholes model, fallacy of the efficient-markets hypothesis, among others. Proper questions are, however, why people got extremely greedy,

why mortgage originators had to be predatory, why so much money flooded into incredibly dubious investment schemes, why Japan, China and other countries could enjoy massive current account surplus and needed to finance US mortgage loans, why mathematically perfect models got into trouble in the real markets, etc.

I believe that we can understand a series of sporadic financial crises since the 1980s, culminating in the present one, from the viewpoint of the contradiction inherent in surplus capital *per se*: i.e. incompatibility between being capital and being surplus at a critical moment. The contradiction manifests itself threefold: as being absolutely surplus, it is redundant to and parasite on the real economy in order to propagate its value; as being relatively surplus, it suffers from gradual deterioration in parasitizing income gains such as interests and dividends; and as being absolutely and relatively surplus in the form of securities, the source of parasitism develops and transforms from income gains into capital gains (i.e. cannibalism among investors) through speculation in securities and other markets. Over a series of business cycles, speculation and mutual predation in a whole spectrum of financial products prevails and gathers momentum more and more. This is because, as a result of repetition of booms and busts, the magnitude of international surplus capital has ever been increasing sporadically after each recession.

A financial bubble in fictitious capital, however, would not burst by itself unless accompanied or led by a bubble in the real economy, i.e. over-production and over-accumulation of capital in information and communication industries in the late 1990s and in housing industries in the middle of the 2000s. It is typically characterized by the fact that capital accumulation still proceeds for some years at the last stage of an economic boom despite the profit rate already beginning to deteriorate. An exuberant and speculative expansion of fictitious capital induces and fans over-accumulation of real capital. That eventually leads to a set of disequilibria among industries, sectors, regions, etc. and to a substantial increase in real wage rates. And finally when over-production and over-accumulation reaches an inevitable limit of private consumption, the boom turns into a burst: a sudden contraction of investment in plants and equipments takes place, which is usually heralded by a credit crunch and a collapse of stock markets.

A vicious combination between over-accumulation of real capital and over-speculation of fictitious capital actually occurred in the IT bubble and the housing bubble in the US. Its colossal current account deficit has never worked as a hindrance: a massive inflow in its financial account has more than compensated current account deficit and worked just like the inexhaustible cornucopia of international surplus capital. An abrupt, though overdue, seizure took place in summer of 2007, when the US housing market undeniably got into trouble and credit lines were overstretched. All the premises on which the perfect-markets hypothesis and the Black-Scholes model are based began to turn upside down: the interbank credit market got frozen; short-term credits no longer rolled over; liquidity dried up here and there; and usually uncorrelated financial products became highly correlated with each other. Linkages broke down among financial products via derivatives, leverage turned into deleverage, and securitization ceased to exist. The contradiction inherent in surplus capital *per se* reached its critical moment and finally exposed itself in a systemic panic; surplus capital was denied to be capital and left

only to be surplus.

5 Concluding Remarks on Economic Methodology

A Nobel Prize laureate P. Krugman gave lectures on the crisis in economy and in economics in the Lionel Robins Lectures in the London School of Economics and Political Science in June 2009 (The Economist, June 13th and July 18th, 2009). His verdict on the state of economics, which was unwillingly exposed by the current global financial crisis, is simply sobering like a cup of coffee in the midst of irrational exuberance. He said that most macroeconomics of the past 30 years was "spectacularly useless at best, and positively harmful at worst". In a word, summarized in the magazine, he and other critics argue that economists missed the origins of the crisis, failed to appreciate its worst symptoms, and cannot now agree about the cure. As concluding remarks, I would like to deliberate on economic methodology, inspired by Krugman's bleak assessment of modern economics.

Whether we agree to his criticism or not, the general question given to all economists seems to be how correctly and convincingly we can describe and explain movements of economic phenomena; in other words, how to construct a dynamic economic theory on a financial and economic crisis. A mathematical model of an economy assumes some strict premises, which keep consistent and intact throughout, and it allows a researcher to observe changes in dependent variables. A problem is, however, that analytical premises may well change discontinuously over time in the real economy, and that relations once captured among variables may be denied by their own dynamic developments. That can happen quite often either as exogenous historical conditions change or as endogenous development of the object takes place. The latter case of endogenous development can be properly treated only by a conceptual analysis: qualitatively discontinuous changes in premises or framework of an analysis are regarded as a necessary process in which the concept of the object develops its inherent forms one by one over time.

The case of the efficient-markets hypothesis serves as a good example for contrasting mathematical model building and conceptual analysis. The hypothesis, or perfect trust on smooth functions of all the financial markets, holds quite comfortably under the condition of mild speculation splitting roughly equally on both sides of bear and bull. All kinds of financial products are consistently linked together thanks to derivatives between short and long and between spots and futures. Their correlations and uncorrelations are stable altogether. We can safely assume the normal distribution of changes in their market values.

However, as we observed above, surplus money capital accumulates sporadically on an ever expanding scale over a series of business cycles, and serves as an additional source of speculative capital. Long-term deterioration of its profitability as a whole of fictitious capital makes it indispensable to shift from income gains to capital gains, and thus makes it unavoidable to strengthen its speculative activities. The process, if and when combined with over-accumulation of capital in the real economy, proceeds willingly or unwillingly towards an economic crisis.

The analytical concept we used is surplus capital on a global scale, and the process we identified is one in which the concept endogenously develops its inherent forms one by one: i.e. absolute, relative, and absolute and relative surplus capital. The process includes a specific period in which the efficient-markets hypothesis and normal distribution can hold perfectly well, but it also includes the following period in which cumulative pressure of speculation distorts the very premises we set at the beginning, and forces malfunction and self-destruction of the economic system as a whole. The driving force of the process is the contradiction inherent in surplus capital *per se*. We may call it dialectics of surplus capital.

I believe in validity and usefulness of the conceptual analysis on the dialectical basis, which does not necessitate the mathematical straight jacket embedded in the neo-classical type of models. It exerts flexible explanatory power and provides researchers with fruitful insights and implications, especially when they deal with long-term economic phenomena in the actual economy with a lot of structural transformations.

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