EXPOSING STUDENTS TO A 360-VIEW OF ECONOMICS THROUGH MULTI-PARADIGMATIC APPROACH: THE CASE OF RECENT FINANCIAL CRISIS

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Abstract

Any explanation of the causes of the recent financial crisis is based on a worldview. The premise of this paper is that any worldview can be associated with one of the four broad paradigms: functionalist, interpretive, radical humanist, and radical structuralist. This paper takes the case of the recent financial crisis and discusses it from the four different viewpoints. It emphasizes that the four views expressed are equally scientific and informative; they look at the phenomenon from their certain paradigmatic viewpoint; and together they provide a much broader, deeper, and balanced understanding of the phenomenon under consideration.

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I. Introduction

In order to understand the explanations of the causes of the recent financial crisis it is necessary to understand their underlying worldviews. This paper is based on the premise that any worldview can be associated with one of the four broad paradigms: functionalist, interpretive, radical humanist, and radical structuralist. This paper takes the case of the recent financial crisis and discusses it from the point of view of each of the four paradigms or worldviews. The paper emphasizes that the four views expressed are equally scientific and informative; they look at the phenomenon from their specific paradigmatic viewpoint; and together they provide a much broader, deeper, and balanced understanding of the phenomenon under consideration.

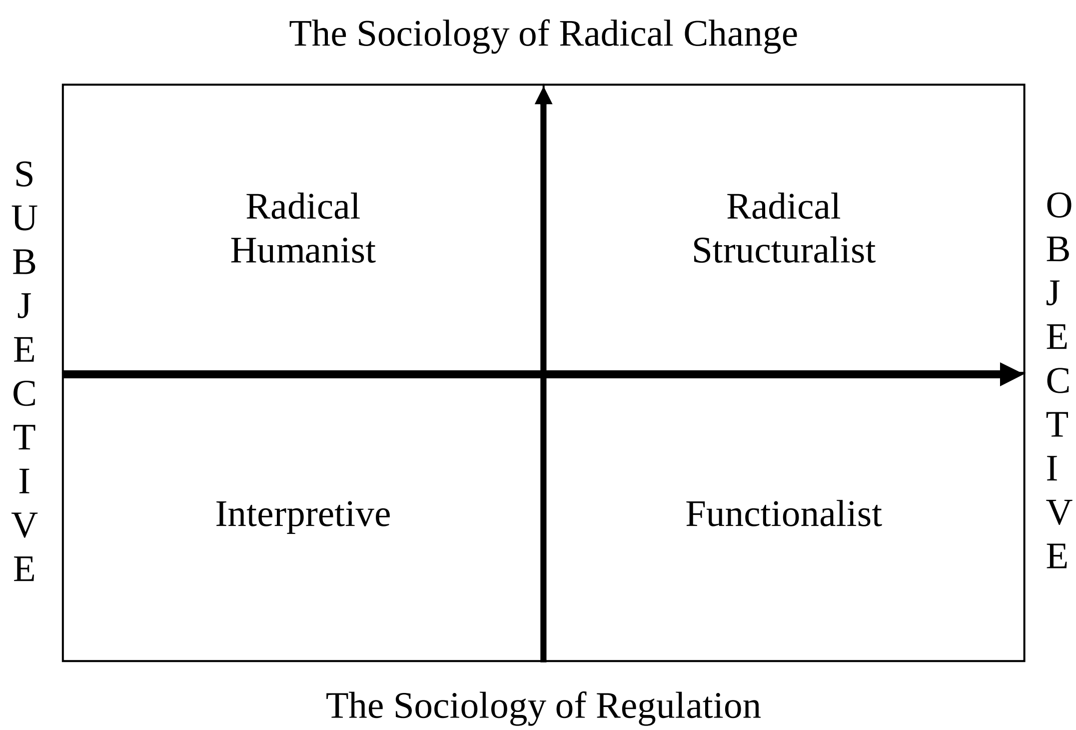
Burrell and Morgan (1979) suggest that social theory can usefully be conceived in terms of four key paradigms: functionalist, interpretive, radical humanist, and radical structuralist. These adhere to different sets of fundamental assumptions about; the nature of science (i.e., the subjective-objective dimension), and the nature of society (i.e., the dimension of regulation-radical change), as in Exhibit 1.[1] Each generates theories, concepts, and analytical tools which are different from those of other paradigms. Based on Burrell and Morgan (1979), Ardalan (2012) summarizes the discussion of the four paradigms as follows:

> "The functionalist paradigm assumes that society's existence is concrete and orderly. These assumptions lead to the view that the social science is objective and

[1] See Burrell and Morgan (1979) for the original work. Ardalan (2008, 2009, 2011, 2012) and Bettner, Robinson, and McGoun (1994) have used this approach in the fields of economics and finance.

Exhibit 1: The Four Paradigms

Each paradigm adheres to a set of fundamental assumptions about the nature of science (i.e., the subjective-objective dimension), and the nature of society (i.e., the dimension of regulation-radical change).



> value-free and that it can provide the true explanation and prediction of the social reality that exists "out there." It assumes that the external world is governed by external rules and regulations. Scientists' role is to find the orders that prevail within the subject of their analysis.
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> The interpretive paradigm assumes that individuals' network of assumptions and intersubjectively shared meanings constitutes social reality. It, therefore, believes that communities of individuals share multiple-realities which they sustain and change. It regards the role of the interpretive researchers as finding the orders that prevail within the phenomenon under their consideration; however, these orders are not regarded as objective.
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> The radical humanist paradigm provides critiques of the status quo and is concerned to articulate the sociology of radical change, modes of domination, emancipation, deprivation, and potentiality. It views the consciousness of human beings as dominated by the ideological superstructure the social system. They seek to change the social world through a change in consciousness. Radical humanists believe that truth is historically-specific.
>
> The radical structuralist paradigm assumes that reality is objective and concrete. Sociologists working within this paradigm analyze the basic class interrelationships within the total social formation and emphasize that radical change is inherent in the structure of society and takes place through political and economic crises. It is through this radical change that the emancipation of human beings from the social structure is materialized."

The aim of this paper is not so much to create a new piece of puzzle as it is to fit the existing pieces of puzzle together in order to make sense of it. Each of the sections II to V examines the causes of the recent financial crisis from the point of view of the respective paradigm.[2] Section VI concludes the paper.

II. Functionalist View

According to the functionalist paradigm, the following provides a number of factors that have been identified as the causes of the recent economic and financial crisis.[3]

[2] For a discussion of the benefits of multi-paradigmatic approach, see Ardalan (2008).

[3] See, for example, Babus, Carletti, and Allen (2009), Bhattacharya and Yu (2008), Brunner (2009), Caprio, Demirguc-Kunt, and Kane (2010), Diamond and Rajan (2009), Gorton (2010), Marsh and Pfleiderer (2010), Obstfeld and Rogoff

Imprudent Mortgage Lending: When credit was abundant, interest rates were low, and house prices were rising, lending standards were relaxed such that many people bought houses which they could not really afford. As house prices started falling and loans began going bad, the financial system was hit by a severe shock.

Housing Bubble: The Federal Reserve followed expansionary monetary policies that allowed housing prices to rise to unsustainable levels. Finally, the burst of the housing bubble triggered the crisis.

Global Imbalances: Some countries (such as China, Japan, and Germany) ran large surpluses every year, while others (such as the U.S and U.K.) ran deficits. The U.S. external deficits was compounded by internal deficits, i.e., the household and government sectors. The U.S. borrowing accumulated over time and placed severe stress on the system that finally resulted in financial disruptions.

Securitization: Securitization reduced lenders' incentives to be prudent. It internationally spread the "originate-to-distribute" model, especially when there was a vast investor demand for subprime loans packaged as AAA bonds. This wide ownership of mortgage-backed securities had repercussions throughout the global system when subprime loans went bad in 2007.

Lack of Transparency and Accountability in Mortgage Finance: Throughout the housing finance industry, many participants contributed to the creation and sale of bad mortgages and bad securities. Lenders sold exotic mortgages to home-owners and traders sold toxic securities to investors, apparently without fear of bearing personal responsibility in case those contracts failed. It was due to the lack of participant accountability that the originate-to-distribute model of mortgage

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(2009), and Reihnart and Rogoff (2010). This section is based on Jickling (2009).

finance, with its great promise of managing risk, became a massive generator of risk.

Rating Agencies: The credit rating agencies incorrectly assigned AAA ratings to various issues of subprime mortgage-backed securities, of which many were subsequently downgraded to junk grade. The reasons for the rating agencies' failure have been: use of poor economic models, conflicts of interest, and lack of effective regulation. Another reason is the market's excessive use of ratings, which has been promoted by numerous laws and regulations that necessitate the use of ratings in determining permissible investments or required capital levels.

Mark-to-market Accounting: FASB standards require financial institutions to report on their financial statements the fair (i.e., current market) value of their financial assets. According to this requirement, banks have to recognize losses based on "fire sale" prices, which prevail in distressed markets and are known to be below long-run fundamental values. These losses deteriorate market confidence and amplify banking system problems.

Deregulatory Legislation: The Gramm-Leach-Bliley Act (GLBA) and the Commodity Futures Modernization Act (CFMA) allowed financial institutions to engage in unregulated risky transactions on a large scale. Unfortunately, the laws were based on faith in self-regulating markets.

Shadow Banking System: Risky financial activities – such as the use of leverage, borrowing short-term to lend long, etc. – which were limited to regulated-banks moved outside the explicit government safety net which was provided by deposit insurance and safety and soundness regulation. In particular, mortgage lending migrated from banks to unregulated institutions. This unsupervised risk-taking led to the financial crisis.

Non-Bank Runs: When non-bank financial institutions – i.e., financial institutions outside the banking system – took financial positions based on borrowing short-term and lending long-term, they exposed themselves to liquidity risk in the form of non-bank runs, as happened to Bear Stearns, etc.

Off-Balance Sheet Finance: Many banks established off-the-books special-purpose entities –such as structured investment vehicles, or SIVs – in order to engage in risky speculative investments. These enabled banks to hold less capital reserves against potential losses. Consequently, with the onset of the crisis, it drastically reduced market confidence in banks' creditworthiness.

Government-Mandated Subprime Lending: To help low-income borrowers – e.g., the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac's affordable housing goals – federal mandates forced banks to engage in risky mortgage lending.

Failure of Risk Management Systems: Some firms compartmentalized the analysis of market risk and credit risk. Such dichotomy did not work for complex structured products, for which those risks were indistinguishable.

Financial Innovation: New instruments in structured finance developed so rapidly that market infrastructure and systems were not yet properly in place when those instruments came under stress. That is, accountants, regulators, ratings agencies, and settlement systems were not given time to catch up.

Complexity: Certain financial instruments were complex in three respects: (1) investors were unable to properly judge the merits of investments, (2) risks of market transactions were unknown, and (3) regulators were confused. The complexity of these financial instruments was at the heart of the crisis.

Human Frailty: Behavioral finance emphasizes that investors do not always make optimal decisions due to "bounded rationality" and limited self-control. Therefore, in complex financial situations, regulators should help them by better disclosure and through reinforcing financial prudence.

Bad Computer Models: Expectations of the performance of complex structured products linked to mortgages were formed based on only a few decades of data. For subprime loans, only a few years of data were used. Complex systems can go beyond historical experience.

Excessive Leverage: In the years prior to the crisis, interest rates were low and capital was abundant, and the yield on fixed income securities was low. To enhance the rate of return on their capital, many investors used borrowed funds in their investments. This excessive leverage magnified the impact of the housing downturn. The consequent deleveraging caused the interbank credit market to tighten.

Relaxed Regulation of Leverage: The Securities and Exchange Commission (SEC) by liberalizing its net capital rule in 2004 allowed investment bank holding companies to increase their leverage ratios to very high levels. In addition, its Consolidated Supervised Entities program, which applied to the largest investment banks, was voluntary and ineffective.

Credit Default Swaps (CDS): Initially, credit derivatives developed for risk management. Then, they continued to grow and became more sophisticated with the help of financial engineering. Later, they became an instrument for speculative transactions, such that credit derivatives increased, rather than decreased, risk.

Over-the-Counter Derivatives: The OTC derivatives – including credit swaps – are largely unregulated. A dealer's default could not only impose substantial losses to counterparties, but also trigger panic because of the uncertainty about the extent and distribution of those losses.

Fragmented Regulation: The regulation of U.S. financial system is dispersed among various agencies. Consequently, no single agency is capable of monitoring emerging system-wide problems.

No Systemic Risk Regulator: No single regulator, in the US, had jurisdiction over all systemically-important financial institutions. Even the Federal Reserve, which had the role of systemic risk regulator, lacked authority over investment banks, hedge funds, non-bank derivatives dealers, etc.

Short-term Incentives: Traders and managers at many financial institutions receive an annual bonus, which constitutes a large portion of their compensation. Therefore, they lack incentives to avoid risky strategies which might fail drastically every five or ten years.

Tail Risk: Many investors and risk managers tried to increase their returns by providing insurance or writing options against low-probability financial events. A good example is credit default swaps. When market participants are aware that many such potential losses are distributed throughout the financial system, but do not know exactly where or how large they are, uncertainty and fear are magnified when markets come under stress.

Black Swan Theory: This type of crisis take place only once during a century. It is caused by a multitude of factors that are so rare that it is impractical to erect regulatory barriers against their recurrences. Such regulations would be so onerous that they basically suppress the growth rate of the US economy and the US standards of living.

III. Interpretive View

According to the interpretive paradigm the determinants of national output and employment are historically-contingent and institutionally-determined.[4] Social institutions are the key to economic regulation. Financial crises form an important aspect of economic life and are an integral part of the business cycles. Unemployment is the outstanding defect of capitalism; the business cycle is the most important cause of unemployment; and the credit cycle is at the root of the business cycle. Business cycle is an important cause of unemployment and that attaining greater economic stability requires understanding the operation and evolution of financial institutions.

An adequate understanding of financial instability requires the understanding of "financial instability hypothesis." It states that the capitalist financial system has a tendency to cycle endogenously from a conservative situation called "hedge financing," to a more risky situation called "speculative financing," to an unsustainable situation called "Ponzi financing," and then restart with a conservative situation of hedge financing for another round. That is, a period of moderate prosperity can be quickly followed by a boom, which can far more rapidly turn into a deep recession. Without timely and proper public intervention, the financial-instability cycle can have devastating macroeconomic consequences.

The point of departure of the analysis is the creation and control of resources under actual (real world) capitalist conditions. Such analysis is institutionally specific, that is, it analyzes a capitalist economy with a sophisticated banking and financial system that finances business. This implies that in each period capital asset-owning and capital asset-using businesses have to pay funds

[4] See, for example, Bhaduri (2010), Bibow (2010), Blankenburg and Palma (2009), Bresser-Pereira (2010), Dymski (2010), Fernandez, Kaboub, and Todorova (2008), Riaz (2009), Vercelli (2009), and Wray (2009). This section is based

to banks because prior financing contracts fall due. The Wall Street is the essential theoretical and institutional structure representing financing activities. The Wall Street includes businesspeople and bankers who negotiate liability structures to finance asset holdings and activities of businesses. These liability structures are either validated or repudiated by events that happen in calendar time.

Financial instability and business cycles are inherent characters of a capitalist economy that on the one hand has a “Wall Street” institutional structure and on the other hand has expensive, long-lived capital assets (i.e., specialized plants and equipments). Business cycles are not simply fluctuations taking place within a fixed economic structure. Rather, business cycles represent both causes to and consequence of changes to that structure. In addition, each new cycle presents idiosyncrasies.

The theory of U.S. capitalist development explains how the evolution of capitalism is shaped by its institutional structure, which is always changing as a consequence of profit-seeking activity. In this development, the financial system plays an important role because while production precedes exchange, finance precedes production. While evolution, change, and innovation are more evident in banking and finance; the drive for profits is more clearly the factor making for change. Moreover, since there is a symbiotic relationship between finance and industrial development, the evolution in finance profoundly affects the course of capitalist development.

Government action is an important determinant of capitalist evolution. Public policy affects both the details and the overall character of the economy. Thus, economic policy must be concerned with both the design of institutions and operations within a set of institutions. In addition, in order to shape an economy, a set of goals needs to be defined. There is no price mechanism or “invisible

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on Whalen (2009).

hand" that ensures optimal economic wellbeing; but, there are individuals with collective choices that shape a social system. Furthermore, since the economy evolves endogenously, no single policy regime can provide a once-and-for-all solution to economic problems. That is, in a dynamic world, a single policy regime cannot be expected to resolve the problems of institutional organization for all time.

The theory of U.S. capitalist development explains the evolution of American economy through a series of stages. The most recent evolutionary change involves the transition from managerial capitalism – which accompanied the New Deal – to money-manager capitalism – which emerged in the early 1980s. According to this theory, in the decades after World War II, the U.S. capitalism evolved from a form managed by corporate executives to one controlled by managers of pensions, mutual funds, and other institutional investors, who strive to maximize the value of the assets they manage.

The "basic path" of real-world capitalism is cyclical and each cycle has its own idiosyncrasies. Such idiosyncrasies are largely created through ongoing institutional evolution. Therefore, one should analyze the underlying tendency toward financial instability within the institutional elements unique to the cycle under consideration. From this perspective, the financial structure of the U.S. economy becomes increasingly fragile during a period of prosperity. In the early stages of prosperity, companies in highly-profitable industries are rewarded for taking increasing amounts of debt. Consequently, their success entices other enterprises to engage in similar behavior.

This pattern was clearly evident both in the high-tech industry in the late 1990s and in the housing sector in the early- and mid-2000s. Indeed, construction companies and contractors were not the only entities who took more debt in the 2000s. Homebuyers also took more debt when the housing market heated up. This happened partly because interest rates were low and the stock market had become less attractive in the aftermath of the dot-com crisis. While a long-standing requirement for U.S. homebuyers had been to make a 20-percent down payment on a home; in the mid-2000s, 42 percent of first-time homebuyers and 13 percent of non-first-time homebuyers put no money down to acquire their homes.

In retrospect, it seems that enterprises and homebuyers should have resisted the temptation to increase their indebtedness. However, the incentives at the time are too great to resist and nobody in a robust sector of the economy wants to fall behind due to underinvestment. That is, even if market participants know that the financial crisis will eventually occur, they will not be able to predict at what point in time the financial crisis will actually occur. In the meantime, firm managers and bank loan officers will be rewarded for aggressively pursuing profitable opportunities and gaining competitive advantages. At the same time, cautious managers, operating based on the understanding that a crisis will eventually occur at some uncertain point, will be penalized because their more aggressive competitors will perform better in this short-run.

During economic expansion, both lenders and borrowers fuel the tendency toward greater indebtedness. The same climate of expectations that entices borrowers to acquire more risky financial liability structures also encourages lenders to take a more optimistic view regarding the repayment of the loans which they have granted. In addition to the expansion of borrowing and lending during an economic boom, there is also financial innovation. Indeed, bankers and other financial intermediaries are merchants of debt and therefore strive to introduce innovations with respect to the types of assets they acquire and the types of liabilities they market.

However, the economic boom cannot continue forever. At some point in time, some borrowers who have overextended themselves need to sell some of their assets in order to make their payments which have become due. In the 2008 crisis, early cases among high-profile financial institutions involved the mortgage broker Countrywide and two hedge funds run by Bear Stearns.

Then the financial distress spreads. This occurs because lenders and borrowers form subjective views about acceptable levels of debt. These subjective views are subject to revision and change. As soon as some companies face a shortfall of cash and are forced to sell some of their assets, then lenders and borrowers in the economy start reassessing how much lending or debt is appropriate. Whereas, the accumulation of debt can continue for years, the reevaluation of it (as soon as anything goes wrong) can be sudden.

When banks decide to restrict their lending, people find themselves in a credit crunch. It may be argued that this economic crisis began with the worldwide stock-market downturn in the fall of 2008. However, the March of 2007 evidenced the signs of trouble which were traceable in large part to the “subprime” mortgage market. Then, the credit crunch began in the summer of 2007. Afterwards, the difficulties of 2008 were experienced.

The emergence of a credit crunch spreads financial difficulties from the sector with financial difficulty to the rest of the economy. Credit crunch negatively affects both business investment and household consumption. That is, the burst of a sectoral bubble threatens to trigger an economy-wide recession. This happened in the high-tech sector about a decade ago and in the housing sector more recently in 2007.

While the preceding analysis provides some insights into the 2008 crisis, it becomes more insightful when distinctive institutional features of the crisis are also brought into consideration. The origin of the crisis under investigation can be traced to a large extent to four financial-sector innovations: (1) unconventional risky mortgages which were aggressively marketed to working people; (2) securitization of risky mortgages which received high credit ratings; (3) the rise of hedge funds who took advantage of their unregulated profession and made high-leveraged investments; and (4) the globalization of finance which is the result of the international activities of money-manger capitalism. These four important items underscore the emphasis on both the evolution of financial system and the notion of money-manager capitalism.

In short, the global economy has been shocked by the crisis. Its origins were in a housing boom fueled by rising expectations, expanding debt, and financial innovation. Then the bubble burst, created a credit crunch, followed by a broader banking and stock-market crisis, and finally a severe recession.

IV. Radical Humanist View

According to the radical humanist paradigm, in this era, the world financial order is characterized by emerging relative stability.[5] The current organization of credit practices has been gradually forged and legitimized around the neo-liberal organizational principles of governance. Neo-liberal political economy offers a set of organizational principles or discourse of governance which is contested throughout the contemporary wider world order. Such organizational principles

[5] See, for example, Erturk, Leaver, and Williams (2010), Gowan (2009), Helleiner, Pagliari, and Zimmermann (2009), Negi (2009), Panitch and Gindin (2009), Seabrooke (2010), Sinclair (2010), Wigan (2010), and Wolff (2009). This

play a significant role in carrying forward the restructuring that has marked the showdown of neo-liberal politics. Neo-liberal organizational principles of governance are founded in the belief that the market mechanism and market mode of behavior constitutes the fair and rational arbiter in society. Particularly, neo-liberalism claims universalism and consequently deems market institutions as "apolitical" and the most "naturally" appropriate institutional loci for governance. Institutionalized practices become legitimate only when they are framed by market signals and subject to market-reinforcing self-regulation. State institutions tend to organize their practices away from bureaucratic professionalism and toward a new public managerialism, according to which social and political issues become matters to be managed and subjected to techniques and procedures. Moreover, since neo-liberal political economy is based on empiricism and positivism, neo-liberal organizational principles of governance legitimate the governance role of particular experts who are viewed as holding, producing, and verifying specific forms of knowledge. Neo-liberalism's predilection for self-regulation deems certain experts – most notably auditors and accountants – to be the most appropriate supervisory institutions.

Throughout modern world finance, financial crises have appeared as important phenomena in the process of unraveling or reproduction of successive financial orders. The resolution of financial crises through structures of governance has played a vital role in the reproduction of financial orders. During periods of relative stability, the resolution of financial crises prevents the superficial problems in credit practices that arise in a crisis from escalating into structural disruption and the unraveling of the prevailing financial order. Periods of relative instability are those periods in which considerable contestation surround the appropriate organization of credit practices. Financial crises

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section is based on Langley (2002).

that exist during periods of relative instability might contribute to the unraveling of a financial order. This is because such financial crises expose weaknesses in the ability of the formal institutions of governance to manage credit practices. This has indeed been illustrated by the financial crises of the late eighteenth century and 1929-31.

The contemporary financial order is very prone to crises. In 1996, the International Monetary Fund (IMF) reported that of the Fund's 181 member states, 133 had experienced disruptions to banking practices between 1980 and early 1996. The report classified 108 instances of disruption as "significant," and 41 instances in 36 states as "crisis." In many instances of "crisis," disruptions caused a drastic reduction in the gross domestic product (GDP). The report noted that both the high frequency of crises and the extent of their detrimental effects on economic growth were worse than any similar period since the Great Depression of the 1930s. This report illustrates that over time the contemporary financial order has lurched from one major crisis to another. Each of these major crises is widely interpreted as having a so-called "systemic threat." That is, each crisis causes such disruptions to credit practices that could be sufficient to lead to world structural disruption. To date these crises have included the debt crisis of the early 1980s; the stock market crash of 1987; the European Exchange Rate Mechanism debacle of 1992-3; the Mexican crisis of 1994-5; the Asian crisis of 1997-8 and the subsequent Russian and Brazilian crises of late 1998 and early 1999; and the global financial melt-down of 2008. Alongside these major financial crises have been major failures of world-scale-operating high-profile market institutions such as the Franklin National Bank, the Banco D'Ambrosiano, the Bank of Credit and Commerce International (BCCI), Barings Bank, Yamaichi, and Long Term Capital Management (LTCM).

The neo-liberal common sense explanation of the major crises of contemporary world finance both reflects and contributes to the forging of relative stability around neo-liberal organizational principles of governance. The neo-liberal orthodoxy views the causal factors in all crises to be domestic and non-market. It deems particular domestic policy decisions and/or institutional arrangements to be inappropriate because they are regarded as perverting the market mode of behavior and forestalling the capacity of the market mechanism to rationally determine exchange rates and the availability or otherwise of credit. It foundationally believes that world credit practices ensure the efficient transfer of capital from areas of surplus to areas of deficit, if there are no political impediments to the market mechanism. It believes that all countries must adopt the right policy framework: monetary policy targeted at low inflation rate; sound and sustainable fiscal policies; structural reforms to improve the supply side performance of the economy; tax systems that work; and strong, properly-regulated and fully-transparent banking and financial systems.

The explanation of crises as the outcome of inefficient national institutions and inappropriate national policies contributes to both the legitimation and the acceptance of the neo-liberal organization of world credit practices.

However, the neo-liberal orthodoxy fails to recognize the inherently subjective nature of all credit practices. A range of recent research into contemporary financial crises has emphasized that shifts in collective market sentiment result in crises. Such market sentiment informs world credit practices and has self-fulfilling potential. Contemporary financial crises and crises which have taken place throughout modern world finance share the same characteristics in terms of the pattern of phases of speculative excess, distress, panic, and crash. Sudden shifts in the opinions of those located at the apex of contemporary market hierarchies typically manifest themselves in a speculative rush of leveraged and short-term portfolio investment and inter-bank lending. But, when the sentiment shifts the process heads into a distressed reverse. Since different national currencies are inextricably locked into the wider financial trends and structures, drastic fluctuations in capital movements also wreak havoc on exchange rates.

The major crises of contemporary world finance are reflections of structural tendencies. This is in sharp contrast to the neo-liberal orthodoxy that views the major crises of contemporary world finance as simply the result of the “wrong” national policy decisions and/or institutional arrangements. The nature of credit practices is inherently subjective and collective. This means that the immediate source of successive contemporary major financial crises has been sudden shifts in the shared meanings and expectations that form world credit practices.

There are also two specific features of recent systemic financial crises. They both arise from the generalized financialization of contemporary credit practices. The first feature of recent systemic financial crises is the higher frequency of crises in the contemporary financial order emanates from financialization. Financialization involves the speculative accumulation of capital through credit practices, which have become a structural feature of contemporary finance order. Such speculative accumulation is based on the subjective identification of opportunities to invest in a specific type of asset, especially when there is intensified competition among market institutions. In practice, contemporary speculation focuses on the on-going and rapid opening and closing of opportunities for accumulation that arise particularly in the course of foreign exchange, securities, and derivatives trading. These speculative investments and the corresponding credit creation to finance them have generated a pattern of largely discrete speculative waves in the contemporary financial order: (1) sovereign lending to underdeveloped state-societies in the 1970s, (2) dis-intermediated and securitized practices to support developed world corporate restructuring during the 1980s, (3) a focus on emerging markets in the 1990s, (4) the "tech stocks" fad at the turn of the millennium, and (5) the "subprime crisis" in the late 2000s. Each speculative wave has been followed by a distressed withdrawal of capital and credit, and in some cases by panic and crash.

The second feature of recent systemic financial crises with reference to financialization also brings to the fore an important contradiction in contemporary world credit practices that reveals itself in the course of crises. The speculative practices of world finance are related to the real practices of world economy, i.e., world production and trade. Claims and obligations that arise from investment and credit creation are typically directly and indirectly claims and obligations on the real economy. The current situation of financialization expresses itself both quantitatively and qualitatively. Quantitatively, financialization expresses itself as the ascendance of financial contracts over real economic turnover. Qualitatively, financialization expresses itself as the subordination of real economic and social relations to the financial system. For instance, since the late 1990s, major corporations and states have increasingly funded the majority of their investment from retained earnings or taxation; but, their obligations arising from world credit practices continue to haunt their corporate and state policy objectives. Secondary trading strategies focused on short-term returns prevent "back sliding" by sovereign and corporate borrowers from the economistic criteria of embedded financial orthodoxy of shareholder value. Credit practices have generated the expectations that all promises must be paid. These promises carry with them assumptions that contribute to shaping the context for the undertakings of those who need credit. When financialization prevails in world credit practices, promises to pay carry with them the assumption that socio-economic relations are commodified. However, the adjustment of social relations in response to pressures for commodification involves significant social, political, and embedded institutional forces. It follows that there is a contradiction between speculative credit practices on the one hand, and the credit obligations that assume the commodification of real socio-economic relations on the other. Taking subtly different forms in specific instances, financial crises erupt as the real economy is not able to consistently meet the obligations and expectations formed by speculative credit practices. The major crises of contemporary world finance share their roots in this structural contradiction that, in different instances, finds expression in the distress and panic of financial market sentiment.

V. Radical Structuralist View

According to the radical structuralist paradigm, changes in capitalism over the last three decades have been typically characterized by using three terms: neo-liberalism, globalization, and financialization.[6] Although the first two terms have been the focus of much writings, much less has been written on the third one. Yet, financialization has increasingly become the dominant force among the three terms. Financialization is the shift in the gravity of economic activity from production and even from the growing service sector to finance. The financialization of capitalism has become one of the key issues of this era.

Although the capitalist system has changed as a result of financialization, it has not entered

[6] See, for example, Altvater (2009a, 2009b), Foster and Holleman (2010), Foster and McChesney (2010), Magdoff and Sweezy (2010), Magdoff and Yates (2009), Meszaros (2009), Palley (2010), and Rosa Luxemburg Foundation (2009).

into a whole new stage of capitalism. This is because the fundamental problem of accumulation in the process of production has remained the same. Instead, within the monopoly stage of capitalism, financialization has resulted in a new hybrid phase which might be called “monopoly-finance capital.” Rather than advancing in a fundamental way, capital has been trapped in seemingly endless cycle of stagnation and financial crisis. The epicenter of these new economic relations of monopoly-finance capital is located in the United States, which is still the dominant capitalist economy. Furthermore, these new economic relations of monopoly-finance capital have increasingly penetrated the global system.

The analysis of the financialization of capitalism does not merely chronicle statistical trends. It views these trends through the lens of a historical analysis of capitalist development. This is succinctly expressed regarding the recent history of capitalism – i.e., starting with the 1974-75 recession – by the three most important underlying trends: (1) the slowing down of the overall rate of growth, (2) the worldwide proliferation of monopolistic (or oligopolistic) multinational corporations, and (3) the financialization of the capital accumulation process.

These three trends are intricately interrelated. Monopolization tends to increase profits for the major corporations, on the one hand; and reduce the demand for additional investment in increasingly controlled markets, on the other hand. The logic of capital is one of more and more profits, which leads to fewer and fewer profitable investment opportunities, which in turn leads to the slowing down of capital accumulation, which further leads to the slowing down of economic growth, because economic growth is powered by capital accumulation. As a result capital found financialization as a way to utilize its economic surplus. The double process of dwindling real

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This section is based on Foster and Magdoff (2009).

investment and of growing financialization first appeared after the peak of the "golden age" of the post World War II decades and has since persisted with increasing intensity.

The monopoly capitalist economy is a very productive system that generates large amounts of surpluses for the small minority of monopolists/oligopolists who are the primary owners of property and the chief beneficiaries of the system. By their very capitalist nature, they tend to invest the surplus for greater accumulation. However, the same system that generates their surpluses also limits their profitable investment. Corporations cannot easily sell their goods to consumers at prices set to yield the going rate of oligopolistic profit. The relative weakness in consumer demand leads corporations to cutback the utilization of productive capacity because corporations avoid overproduction in order to prevent price reductions that threaten their profit margins. The buildup of excess productive capacity indicates to the corporation that there is hardly any opportunity for investment in new capacity.

The dilemma for the owners of capital is what to do with their huge surpluses when there is a lack of investment opportunities. Their main solution since the 1970s has been to increase their demand for financial products in order to maintain and expand their money capital. On the supply side of this process, financial institutions introduced a vast array of new financial instruments: futures, options, derivatives, hedge funds, etc. The result was a substantial increase in financial speculation, which has persisted in the past few decades. Financialization has been functional for capitalism in the context of its tendency to stagnation.

It is true that the casino society channels far too much talent and energy into the financial speculation. But, it is not true that such activities come at the expense of the production of real goods and services. There is no reason to assume that if the financial structure is deflated, the talent and energy which is employed there would transfer into the productive sector. Such resources would simply become unemployed and would be added to the country's already huge reservoir of unemployed resources. Therefore, the casino society is not a significant drag on economic growth. The growth which the U.S. economy has experienced in recent years, apart from the effect of an unprecedented peacetime military buildup, has been almost entirely due to the financial explosion.

Capitalism has undergone a transformation, which is represented by the development of a complex relation that has formed between stagnation and financialization. This financial superstructure emerged roughly contemporaneously with the return of stagnation in the 1970s. This is in contrast to all previous experiences. Traditionally, financial expansion has taken place at the same time with prosperity in the real economy. But, since the late twentieth century the opposite has been nearly the case. That is, now financial expansion feeds not on a healthy real economy but on a stagnant one. Indeed, the inverted relation between the financial and the real is the key to understanding the recent trends in the world economy.

In retrospect, it can be seen that this "inverted relation" has been a built-in possibility for capitalism since its inception. But this possibility could materialize only in a particular stage of the development of the system. This possibility arises from the fact that the capital accumulation process can involve the ownership of real assets as well as the holding of paper claims to those real assets. These circumstances lead to the possibility of a contradiction between real accumulation and financial speculation. This contradiction was intrinsic to the system from the start.

In the 1970s, the old structure of the economy – with finance, as an annex, serving the production system – was still in place. In contrast, by the end of the 1980s this structure changed such that the financial sector greatly expanded, achieved a high degree of autonomy, and prevailed over the underlying production system. The stagnation of the real production and the enormous growth of the financial speculation constituted the symbiotic aspects of the same deep-seated, irreversible economic impasse.

This symbiosis has three crucial features. (1) The stagnation of the underlying production economy implies that capitalists are increasingly dependent on the growth of finance to maintain and increase their money capital. (2) The financial superstructure of the capitalist economy cannot expand entirely independently of its underlying productive economy – thus the burst of speculative bubbles is a recurrent and growing problem. (3) Financialization, no matter how far it is extended, can never overcome stagnation in real production.

The role of the capitalist state is transformed to meet the new priorities set by financialization. The role of the state role as the lender of last resort is fully incorporated into the system. Accordingly, state will provide liquidity at short notice. In response to the 1987 stock market crash, the Federal Reserve adopted the "too-big-to-fail" policy, which did not, however, prevent the sudden decline in the stock market in 2000.

These conditions mark the rise of what is called "monopoly-finance capital," in which financialization is a permanent structural necessity of the stagnation-prone economy. The following addresses some of its concrete class and imperial implications.

(1) Financialization is an ongoing process that transcends particular financial bubbles.

(2) Monopoly-finance capital is a qualitatively different phenomenon from "finance capital,"

which described the role of finance in capitalism in early twentieth century, which was rooted especially in the dominance of investment-banking.

(3) Ownership of a vast amount of financial assets is the main determinant of membership in the capitalist class.

(4) Speculation in housing has been a central aspect of the stagnation-financialization dynamic. It allowed homeowners to borrow against their growing home equity in order to be able to maintain their lifestyles to a considerable extent despite their stagnant real wages. This led to an increase in the reliance on debt by U.S. households. The low interest rates since the last recession encouraged speculation in housing which in turn fueled the housing bubble. Consumer debt service ratios rose, while the soaring house values on which consumers have depended to service their debts disappeared. The rise in interest rates generated a vicious circle of stagnant or even falling home values and the increase in consumer debt service ratios led to a flood of defaults. The burst of the housing bubble became a major source of instability in the U.S. economy. The housing bubble was a crucial counter to stagnation and a basis for financialization. It was closely related to the basic wellbeing of U.S. households. The burst in housing market precipitated both a sharp economic downturn and widespread financial disarray. The fact that U.S. consumption is the core source of demand for the world economy raises contributed to a globalized crisis.

(5) The growth of the financialization of the world economy has given rise to the greater imperial penetration into underdeveloped economies and their increased financial dependence. This is marked by the policies of neoliberal globalization.

(6) The financialization of capitalism has resulted in a more uncontrollable and unstable

system. It is the characteristic of speculative bubbles that as soon as they stop expanding they burst.

VI. Conclusion

This paper briefly discussed four views expressed with respect to the causes of the recent financial crisis. The functionalist paradigm believes that the crisis is a moment of instability in an otherwise well-ordered system and explains it by reference to various contingent factors. The interpretive paradigm believes that a relatively new coherent structure which is called the "new Wall Street System" has generated the crisis. The radical humanist paradigm believes that the subjective nature of expectations in speculative and debt markets leads to financial bubbles which become incompatible with the real production side of the economy. The radical structuralist paradigm believes that the crisis reveals the deeper economic contradictions of capitalism through financialization.

Each paradigm is logically coherent – in terms of its underlying assumptions – and conceptualizes and studies the phenomenon in a certain way, and generates distinctive kinds of insight and understanding. Therefore different paradigms in combination provide a much broader, deeper, and balanced understanding of the phenomenon under consideration. An understanding of different paradigms leads to a better understanding of the multi-faceted nature of the phenomenon.

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