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The Crisis of Finance in Marxian Political Economy

JAN TOPOROWSKI*

THE FINANCIAL CRISIS SINCE 2008 has been analyzed by critics of finance as a crisis of deregulation, financialization, neoliberalism and speculation (most notably by Duménil and Lévy, 2011; see also Turner, 2009 and Phillips, 2014). There was indeed a crisis of liquidity in money and capital markets (Nesvetailova, 2010). But the incidents in the financial markets cannot be understood without a serious critique of how capitalism functions, integrating the theory of production with distribution, and the financing of capital accumulation. Most authors who undertake such a critique have done so by adding a dimension of debt to theories of capitalist production and distribution. Debt is then supposed to exacerbate the contradictions of capitalism by offering new forms of financial accumulation and burdening income with usurious debt payment obligations, a new "regime of accumulation" commonly called "financialization" or "financialized capitalism" (Duménil and Lévy, 2011; Lapavitsas, 2013). In general this literature integrates finance into capitalist production and distribution, as generalized debt. This paper attempts a more complex analysis of finance, showing how finance changes the functioning of capitalist enterprises, and through that the functioning of the capitalist economy and its crises. This deconstruction of finance in capitalism requires not just the incorporation of corporate finance into the analysis of capitalism as a system, but also the identification

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of agency (the capitalist firm) in that system, and how that agency has been changed by finance. That is, it is necessary to examine debt structures, the processes by which balance sheets are modified and kept liquid, and the effects of this on capitalist institutions.

These considerations then point to the dynamics of the present crisis. These dynamics lie behind the incidents in the financial markets that are commonly used in the political economy literature to describe and explain the crisis. The paper argues that the present crisis was initiated in the summer of 2008 by non-financial corporations that had become over-reliant on short-term borrowing to finance merger and takeover activity. The squeeze on the liquidity of non-financial corporations obliged them to reduce fixed investment. This reduction in investment transmitted the crisis to the rest of the economy. It was this reduction that has seriously impaired the ability of economies to support debt structures.

Long-Term Finance and the Critique of Political Economy

Political economy is not received economic wisdom, a set of doctrines that either must be true, or frame research or an approach to political economy because, like Schumpeter's "vision" it is necessary to have a theoretical starting point in any study of society. It is not enough to be able to quote from the work of serious political economists, or derive doctrines from citations, or pepper a text with concepts found in Marx. For a Marxist, it is necessary to show how capitalist production and distribution determine the way in which capitalism has evolved, combined with a systematic criticism of economic ideas and policy (see Marx's Preface to the first German edition of Volume I of *Capital*, or his Preface to *A Contribution to the Critique of Political Economy*; Marx, 1938; 1970). The starting point has to be an understanding of Marx's *project.*

As is well known, Marx's political economy is based on a theory of value showing how value is created. The remaining volumes of *Capital* were supposed to show how value is realized. Volume II is sub-titled *The Process of the Circulation of Capital.* This process is what we now call the circular flow of income, which represents the income flows that Marx described in the schemes of reproduction laid out in this volume. However, he was not satisfied with the draft he had written and intended to revise it. In particular, he presented in the volume a

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scheme of simple reproduction (reproduction without any increase in production, or of the capital stock), but he did not complete the exposition of expanded reproduction (Marx 1974a, chs. XX, XXI). The question of the conditions for realization was to be taken up by Rosa Luxemburg in her *Accumulation of Capital*. In his book on Luxemburg's theory, Tadeusz Kowalik shows that Kalecki's theory of the business cycle is in effect the solution to the problem of value realization that eluded Marx and Luxemburg (Kowalik, 2014, Appendix 1).

Since the writing of *Capital*, a radical change occurred in the functioning of the capitalist economy, in the form of the emergence and proliferation of markets for long-term debt and shares in capitalist enterprises. These markets expanded with legislation from the 1860s onwards that eased the establishment of joint stock companies in the advanced capitalist countries. This transformed capitalism from its "classic" form in the mid-19th century, in which capitalist enterprises were owned and controlled by individual capitalists and their more or less active partners, into its modern, 20th-century form dominated by large joint-stock companies (Kindleberger, 1993, ch. 11). (Engels tried to incorporate this shift into Marx's *Capital* with a short chapter on the stock market that he added to Volume III (Engels, "Supplement to *Capital* Volume Three"; Marx, 1974b). But this did not go beyond deprecating the speculation in that market, in terms that are common currency in modern, superficial critiques of finance.)

This change had two consequences of radical importance for the stability of capitalism. In the first place, large capitalist enterprises with access to capital (long-term debt and equity) markets were able to fund their long-term industrial assets with bonds, or with equity. This reduced their vulnerability to credit shortages. Before this change in financing, the "classic" capitalist enterprise was typically financed with the owner's capital. But as mechanization of production proceeded, there was an incessant need for additional capital that was usually met by short-term bank borrowing that had to be rolled over during the lifetime of the productive capital equipment that it was financing (see Dobb, 1967, 26–30; Niebyl, 1946, ch. 3; Kindleberger, 1993, 94–96). If banks became reluctant to lend, the capitalist entrepreneur (Marx's "functioning" capitalist) would be unable to roll over and, faced with a squeeze on his liquidity, his company could fail. This is the financial crisis that is typical of "classic" capitalism. It was described in the two texts that formed the basis of the theory of financial crisis

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in both mainstream economics and radical political economy: Tugan-Baranovsky's study of English banking crises, which influenced Dennis Robertson and Ralph Hawtrey, as well as John Maynard Keynes; and Henry Hyndman's *Commercial Crises of the Nineteenth Century* (Tugan-Baranovsky, 1923; Hyndman, 1932).

This banking crisis of "classic capitalism," due to the short-term financing of longer-term capital equipment, is now the standard financial crisis theory of mainstream economics and radical political economics: a combination of bank illiquidity, due to maturity transformation, and credit "crunch" as lending facilities are withdrawn due to that illiquidity. In his 1932 preface to the second edition of Hyndman's *Commercial Crises,* J. A. Hobson attributed the characteristics of 19th-century crises to those of the 20th century, with tacit underconsumptionist implications:

> The interest of modern readers will be attracted by the common character of the nine crises of the last century [*sic*], and by the flood of light they throw upon the present troubles of the world. Even in the slump which followed the Napoleonic war the germ of all the later slumps was plainly discernible, the glut of commodities unsaleable by reason of the fall of prices, the stoppage of production throughout the industrial system, and the lingering waste of unemployment. In each succeeding crisis, though financial troubles figured as the immediate cause of collapse, the same paradox which confronts the world to-day was plainly visible, an acceleration of the power of production unaccompanied by a corresponding growth of purchasing and consuming power." (Hyndman, 1932, vii.)

It is also worthy of note that in his book Hyndman did not mention the Barings crisis of 1893, a crisis that originated in the bond market and spread through the stock markets of Europe, Australia and the Americas. Those authors that did write about it have treated it like a bank run, rather than as a crisis of corporate finance (Hawtrey, 1934, 364; Kindleberger, 1993, 275–277). But the change in capitalist financing did affect the organizational forms and structure of the capitalist enterprise, the course of financial crisis, and capitalist dynamics in general. The emergence of long-term debt markets allowed the capitalist entrepreneur to refinance his short-term bank borrowing with long-term bonds. This virtually eliminated the vulnerability of the capitalist to a bank credit squeeze (cf. Hilferding, 1981, 87–88). At the same time, the capitalist entrepreneur had to ensure that his

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company now had sufficient liquid reserves to make interest and dividend payments on long-term debts, or equity, and then to make sure that the holders of the bonds or shares were not embarrassed by the drying up of liquidity in the markets for bonds or shares: such a drying up makes it difficult to sell a bond or share for a good price and condemns its owner to holding it until prices improve, with only a cash flow in the form of interest or dividends. Hence companies are obliged to hold excess capital that is turned over in restructuring their financing.

In the financial markets, financial innovation takes place to provide liquidity for long-term securities: a whole range of new banking and financial institutions financing holdings of long-term securities with short-term borrowing. In "classic" capitalism, bank credit was advanced on trade bills and personal borrowing by capitalists. In the new financial system, with active markets for long-term debt and equity, bank credit could be secured on long-term financial instruments. Early on, economists such as Withers and Hobson noted the shift in the basis of credit from commodity production and exchange to long-term securities (Withers, 1917; Hobson, 1924, ch. 5). Such "layering" of credit (lending in order to buy debt instruments) then constitutes proliferation of debt that is nowadays referred to as "financialization" (because debt stocks rise faster than real economic activity) but is really a way in which the financial system keeps the market for long-term securities liquid. The analysis of the unstable liquidity in the capital markets was addressed in the first half of the 20th century in the work of Thorstein Veblen and John Maynard Keynes, and in the second half by Hyman Minsky (Veblen, 1904, ch. VII; Keynes, 1936, ch. 12; Minsky, 1986). In his *Stabilizing an Unstable Economy* Minsky demonstrated the need for capitalist firms to maintain a certain level of investment expenditure in order to realize profits and make payments on their debts (Minsky, 1986, ch. 8).

The second major change attendant upon the expansion of long-term finance was the rise of monopoly capital. Companies could now expand far more expeditiously by buying their competitors' long-term debts or shares, rather than entering into the precarious business of competing their competitors out of business. The trusts and monopolies that dominated capitalism by the end of the 19th century were the creation of the capital markets, rather than, Alfred Marshall believed, the results of either "natural" monopolies or increasing

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returns to scale. For Rudolf Hilferding and observers of "trustified" capitalism, the capital market, rather than the product market, creates monopoly capitalism. In his *Finance Capital* Hilferding first put forward an explanation of the new capitalist instability, caused by the interplay between monopoly and competitive segments in the capitalist economy (Hilferding, 1981, ch. 20). This was a theme that was to be later systematically investigated by Michał Kalecki, who thought that he was addressing Rosa Luxemburg's and Mikhail Tugan-Baranovsky's respective explanations of the conditions under which value is realized in the capitalist economy, but was really engaged in a critique of Hilferding's conclusion that cartelization stabilizes capitalism (Kalecki, 1967; 1932). In the second half of the 20th century, the analysis of monopoly capital came to be associated with Paul Sweezy (see, in particular, Magdoff and Sweezy, 1987).

Finance and the Critique of Political Economy Since the Twentieth Century

Following Alfred Marshall, mainstream economic theory dispensed with a theory of value and regressed into a theory of the firm in which profits are merely a margin over costs of production. That margin is given "naturally" (because it is so obvious in a profitable enterprise) by capital productivity, so that both the question of value and its realization disappear from neoclassical economics. In neoclassical theory, monetary theory is determined in the "sphere of commodity circulation" by the exchange relation, with interest rates determined in a market for "saving" or "savings" (unspent income). With the widespread acceptance since the 1970s of "micro-foundations" as a necessary methodological principle, the capitalist firm and its financing disappear from the mainstream narrative, replaced by exchange of surplus commodities between households, so that production and exchange are the results of household decisions. Finance is transformed into household decisions on savings portfolios, and corporate finance has been reduced to the choice of financing for household-based firms, and their "information" and principal–agent problems, as if a century and half of financial development and innovation had simply not happened (see Shabani and Toporowski, 2015).

Outside the mainstream, post-Keynesianism, perhaps the only modern school of thought in economics that has taken finance

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seriously, proceeds in general using flow of funds sectoral balances, into which fiscal policy (the original "Keynesian" policy) may be fitted conveniently as a balance between the private sector net accumulation of assets (saving minus investment) and the trade balance (*e.g.*, Palley, 2010). The strength of the post-Keynesian approach, apart from its integration of finance into its monetary analysis, lies in its theory of aggregate demand laying down the conditions under which value is realized. However, this is not integrated with any theory of value or production and the theory of distribution is usually treated as an optional supplement to the theory of aggregate output and employment.

With the exception of Paul Sweezy and his followers, Marxist political economy in the second half of the 20th century engaged in a critique of Keynesian theory, for its lack of a theory of production and value. This critique then indicates the theory of value as the distinctive feature of Marxian political economy. An increasingly narrow focus on the law of value as the analytical core of Marxism has largely excluded from Marxian political economy the other part of Marx's project, namely the analysis of the conditions for the realization of value. While the "regulationist" and "social structure of accumulation" schools of Marxist theory have accommodated into their analysis the state as the organ determining the conditions for the realization of value, Marxists in general have not followed up on the work of Luxemburg and Hilferding to analyze the conditions for the realization of value that emerge directly from capitalist relations of production, those conditions being the accumulation of capital and its financing. The result, among most Marxists, has been a retrogression to Ricardian socialism, reducing capitalism to a theory of capitalist production and a labor theory of value, in which crisis comes from the underconsumption of workers. Key factors in the crisis are supposed to be not so much problems in production (which are supposed to have been eliminated by the weakening of organized labor from the 1980s onwards) but a combination of state policies of neoliberalism, deregulation and speculation. In the absence of any broader analysis of the conditions for the realization of value, most Marxists, like the post-Keynesian wage-led growth theorists, argue that any realization problem in capitalism arises because workers are not paid the full value of their labor.

The high visibility afforded to finance in recent years by its extravagance, in the years before the financial crisis of 2008, and its

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apparent position as the crucible of crises since that year, has highlighted the inadequacy of theories that see the economy as either a set of household exchanges, or a set of sectoral flows of funds, or merely a theory of value and production, with an accompanying state operating monetary and fiscal policy. Theories of financialization have been advanced to incorporate the large amount of debt transactions into theories of household exchanges, or sectoral flows, or theories of value and production (*e.g.*, Duménil and Lévy, 2011; Lapavitsas, 2013). However, without an analysis of the conditions for the realization of value, those conditions being principally the accumulation of capital and its financing, theories of financialization cannot provide an adequate account of the corporate finance that lies at the heart of the capitalist economy (Toporowski, 2012).

The remainder of this paper gives an account of the corporate finance, rather than the dramas of finance houses, that set off the present depression in Europe.

The Crisis of Accumulation Since 2008

For the reasons explained above, corporate finance has been largely overlooked in explanations of the 2008 crisis. The neglect of corporate finance is a casualty of the dismissal of the firm as the key economic decision-maker in the economy. Hence the part played by corporate finances of large corporations has not really been considered as central to the macroeconomic analysis of the financial crisis (a rare exception here is the study of Cemex given in Vargas y Albino Luna, 2012).

In examining the role of corporate finance in the financial crisis, or indeed in any economic conjuncture, a distinction needs to be made between non-financial business corporations and small and medium-sized enterprises. The defining feature of business corporations is that their corporate treasurers have access to the full range of financial markets, from banks, through capital markets, right up to derivatives markets. At the extreme, in the case of multinational corporations, they have access to financial markets in all parts of the world where they are not excluded by capital controls (as in China or India). This allows such corporations to take full advantage of long-term debt markets, to stabilize their financing costs, for example through the issue of shares on which payments and repayments, in

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the form of dividends and share buy-backs, are at the discretion of the management, rather than determined by inflexible financial contracts. Long-term obligations like this also avoid the need to roll over debt.

At the other extreme are small and medium-sized enterprises that constitute Hilferding's competitive segment of capitalist enterprises. These enterprises usually operate with finance borrowed from a bank, finance that is usually of a limited term, payments on which are contractually determined. Access to a limited range of other financial services, *e.g.*, leasing or foreign currency, is usually obtained through a given bank. In many countries (most notably in Germany) there exists a stratum of local banks specifically designated to provide financial services to small and medium-sized firms. This limited access to financial services by smaller companies, sometimes referred to as a "financing gap," is the subject of a large literature, and policies to encourage venture capital and capital market–like facilities (a particular enthusiasm in the European Union under the Lisbon Agenda; see Frangakis, 2009). Although this is not the place to give any comprehensive treatment of the topic, it is commonly forgotten in the discussion that the amount of risk capital in an economy at any one time is limited by the size and structure of the liabilities of long-term investment institutions (Toporowski, 2010). The provision of unlimited capital to all enterprises would require a massive inflation of the capital and long-term debt markets that, without a corresponding inflation of intermediary institutions to maintain the liquidity in those markets, would increase financial instability well beyond anything that has been experienced so far in the capitalist world. In effect, restriction on access to the capital market is a stabilizing factor, for that market, in an otherwise unstable financial system.

Apart from access to the capital market, there is another economic distinction to be made between corporations and small and medium-sized enterprises. This is that, despite the existence in some countries of an important segment of medium-sized enterprises that engage in fixed capital investment and even technological innovation, in general it may be said that in virtually all capitalist countries, large industrial corporations account for the vast bulk of fixed business investment. Since such investment is the key private-sector determinant of the business cycle, it is usually this (rather than government policy) that creates a given macroeconomic conjuncture of boom or recession. This is further explained below. Nevertheless, also in virtually all capitalist

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countries, it is the small and medium-sized enterprises that account for the majority of non-agricultural private sector employment. Thus it is, in the private sector, large corporations that, through their investment (or capital accumulation), determine aggregate demand and employment (or the realization of value), but small and medium-sized enterprises that actual employ most workers in the private sector. This now gives us a framework for understanding how the present economic crisis was created in the sphere of corporate finance.

The key mechanism was described in a report in the Business Section of *The Economist* on December 13, 2008 ("Riding the Roller-coaster," pp. 73–74) revealing the key relationship between debt, capital market inflation and investment in the economy. The report reviewed the accounts of the six largest industrial multinational companies in basic materials production. These companies had incurred net debts of $136 billion. The usual Keynesian, Austrian, Fisherian and Minsky analysis of the business cycle would suggest that this arose because of those companies' enthusiasm for fixed capital investment. In fact, the report states, four-fifths of this debt was spent on mergers and acquisitions, driving the leverage ratio (ratio of net debt to equity) of these companies to an average of 2.6 (4.4 in the case of the acquisition-hungry Cemex; 4 in the case of Lafarge; and 3.5 in the case of Tata Steel).

With borrowing at an unsustainable level, what could the companies do? "Raising equity is tricky, since investors had been sucked dry by capital-hungry banks" (confirmation that the supply of equity is not as elastic as theory would suggest; see Toporowski, 2009). Nor would asset sales generate much cash inflow: "disposals could occur only at miserly prices, if at all, because most potential buyers have no access to funds themselves." The report concludes by identifying the mechanism that appears to the companies, and to the author of the report, to be the most effective way of cutting their debt:

> In the fight to survive, the biggest weapons are cuts in production and capital spending. ArcelorMittal has led the way on the former with a reduction of output by one third that even its chairman, Lakshmi Mittal, calls "very aggressive." The cuts to investment plans are as dramatic: ArcelorMittal, Lafarge and Cemex have sliced their budgets for next year by between one-third and one-half, and on December 10 Rio (Tinto) cut its planned capital expenditure in 2009 from $9 billion to $4 billion. Xstrata has yet to announce its

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plans, but a 50% reduction is possible. (In the event, Xstrata cut its planned capital expenditure by $3bn, leaving capital expenditure of $3.2bn.). (*Op cit.*)

The report concluded that these expenditure cuts "would mean a $15bn boost in annual cash flow — equivalent to about 18 months' worth of interest costs. . . . It is a glimmer of hope during these bleakest of times." One may forgive a journalist for failing to see beyond the balance sheet that a corporation is trying to repair. But those familiar with the analysis of Fisher, Keynes, Kalecki, Minsky and Steindl know that this way of dealing with excess debt is the mechanism of economic depression in a finance capitalist economy: large corporations are foolish to suppose that their cash flow, or sales revenue, would stay unchanged if they reduce their investment on the scale done by those corporations in 2008.

Subsequent reports of the debt problems of large companies (*i.e.*, companies with access to the capital markets) have confirmed that it is not their fixed capital investments, but their capital market operations that have driven those companies into difficulties. A report on Tata Motors, promoting its latest venture in car production in India ("The Tata Nano, The New People's Car — Why the Nano Alone Cannot Solve Mounting Problems of Its Maker," *The Economist*, March 26, 2009), could not overlook the financial difficulties of this branch of the Tata empire. The report revealed that Tata Motors had a financial deficit that was expected to be at least $3.4bn in 2009. "About $1.4bn of that is in the form of short-term loans raised for working capital." The remaining "$2bn relates to the bridging loan taken out last year [*i.e.*, in 2008] to finance its $2.3bn purchase of Jaguar Land Rover (JLR), a British premium carmaker, which must be either repaid or refinanced in June [2009]." At the end of 2008, "an attempt to raise $885m through a rights issue ended up with Tata Sons, the group holding company, taking up 61% of the ordinary shares." In other words, the capital market was unable to provide most of the equity capital that the company needed.

Perhaps the most curious relationship between a large corporation and the capital markets is that of General Electric. This relationship is curious not only because it reveals so much about how large corporations use financial markets. It also demonstrates the willingness of management experts and economists to accept the claims of business leaders made charismatic by the financial boom. Under Jack Welch,

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its chief executive from 1981 to 2001, General Electric was supposed to be managed in accordance with profit targets requiring quarterly increases in those profits. These were enforced by management techniques that bewitched the business press and the prestigious *Harvard Business Review.* Another report revealed that the rise in profits was in fact increasingly due to the financial operations of General Electric's financial subsidiary GE Capital ("General Electric: Losing Its Magic Touch," *The Economist,* March 19, 2009). GE Capital had been set up in 1932 as the General Electric Contracts Corporation to assist in financing the company's industrial activities. However, by the 1980s GE Capital was in effect operating like a bank, raising funds through bond issues and commercial paper to invest in various financial assets. During the period of financial market inflation, GE Capital became a useful source of additional profits: if General Electric was due to miss its profit target, GE Capital would sell financial assets, above their purchase price because of the inflation of the capital market, to generate the profits required. It was not the much-touted efficient management of industrial resources that made General Electric so profitable, but the operations of its banking subsidiary GE Capital in the shadow banking system.

In 2008, General Electric was plunged into difficulty when GE Capital found itself unable to roll over commercial paper due for repayment, and holding assets that could not be sold except at a loss. As a bank GE Capital benefitted from U. S. government measures to support banking. However, the company lost its valuable AAA credit rating, which was cut in March 2009 to AA+, and was forced to cut its quarterly dividend by two-thirds, the first time the dividend had been reduced since 1938. General Electric was forced to raise $15bn of new capital from a consortium that included Warren Buffett's Berkshire Hathaway.

Overall, the OECD data shows a decline in fixed capital investment in plant and machinery in the countries most exposed to the financial crisis between 2007 and 2012: 23% in the UK, 15% in the USA (a low investment economy) and 18% in the eurozone. It is this decline in investment, rather than any fall in the consumption of indebted households (household consumption fell by 5% during this period in the UK, and actually rose in the USA and the Euro area), that caused the so-called "Great Recession" in Europe and North America.

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Conclusion

The analysis of the recent financial crisis and its subsequent macroeconomic impact cannot be separated from a critique of political economy in the form of an analysis of how capitalism evolved in the 20th century, and a critique of economic theory and policy. A critique of political economy derived from an understanding of the law of value and the conditions for its realization indicates that the continuing financial difficulties since 2008 are rooted in the balance sheet problems of capitalist corporations, rather than in the incidents of banking at that time. It was not the failure of Lehman Brothers that "caused" the crisis since 2008, but the failure of investment (capital accumulation) on which capitalism depends for the realization of value.

Economics Department
SOAS University of London
Thornhaugh Street
London WC1H 0XG
UK
jt29@soas.ac.uk

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