The Causes and Solutions of Capitalist Economic Crisis

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ABSTRACT

The capitalist economic crisis has brought great damage to the operation of the world economy. The essence of the capitalist economic crisis lies in the inherent contradiction of the capitalist system. Based on the performance of the American subprime crisis in 2008, this paper deeply analyzes the causes of the capitalist economic crisis and puts forward solutions from the analysis of the causes, to avoid risks and prevent them in the future. The study found that the fundamental cause of the subprime mortgage crisis is the basic contradiction of the capitalist mode of production, and the direct cause is the transfer of financial risks. The external cause of the economic crisis is the distortion of financial credit rating and weak supervision, and the reason for the traditional ideological theory is liberal belief.

Keywords: *American Subprime crisis, cause, solution, big company, nationalization policies*

1. INTRODUCTION

Because of the impact of COVID-19 last year, the world economy has been suppressed to varying degrees. The last global economic crisis was the subprime mortgage crisis in 2008. This study mainly explores the causes of the subprime mortgage crisis and effective solutions. It is hoped that the root and direct causes can be found through this study. These past solutions can provide better judgment and analysis of the current economic situation or future trends.

2. THE PHENOMENON OF SUBPRIME MORTGAGE CRISIS

The outbreak of the subprime mortgage crisis in the housing market is the fuse of a financial crisis. The crisis caused by the stimulation of housing mortgage lending institutions will spread to banks, fund companies, insurance companies and other financial institutions, and eventually form the financial and economic crisis of the whole market. From the chain of the financial crisis, we can see that the root cause of the crisis is the relative surplus of products produced by the real economy and the lack of effective social demand what the financial crisis shows is only a small part of real economic problems [1].

Under the capitalist private ownership system, what capitalists pursue is the increment and profit of capital. Due to the competition and profit pressure of the industry, capitalists will invest their capital into the profitable industry to the maximum extent and expand production and put into reproduction in the industry. As a result, some industries are overheated, and the output of products is greatly increased. In Kunhof and Rancière's model, households are broken down into two groups—the richest 5 percent, representing capital; and the bottom 95 percent, representing labor. As in the real world, Kunhof and Rancière assume the capital group experiences large and persistent income gains over time, while wages for labor grow slowly or stagnate. But the top 5 percent cannot consume all their disposable income, so they create financial wealth through loans to the bottom 95 percent, who need credit to maintain their accustomed level of consumption. As inequality grows, credit supply from the top and credit demand from the bottom expand simultaneously, increasing the probability of systemic default as risk and debt build. In this stage, the gap between the rich and the poor in the United States is large, and the consumer desire is far greater than the ability to pay. In the United States, real average annual earnings for production and other non-supervisory workers peaked in 1972 at $40,884, while total consumer credit amounted to just $2,804 per person. By 2008, average annual earnings had fallen by $6,408 to $34,476, and households were making up the gap with an extra $4,940 in credit per person—more than triple the ratio of credit to earnings as in 1972.

Through the unlimited expansion of consumer credit for low-income groups, it stimulated social demand and increased domestic demand in the short term which increased corporate attacks and made profits. Under such a consumption model, major financial institutions and investment banks pay more attention to financial innovation, and use financial instruments such as installment payment, loan consumption, credit card shopping, and stimulus mortgage loans to stimulate overdrafts and promote mass consumption, especially the consumption of low-income residents.. As a result, various bond markets triggered by financial innovation provide conditions for households to consume ahead of time under excess debt.

According to Robert J. Shiller and other economists, housing price increases beyond the general inflation rate are not sustainable in the long term. From the end of World War II to the beginning of the housing bubble in 1997, housing prices in the US remained relatively stable. The bubble was characterized by higher rates of household debt and lower savings rates, slightly higher rates of home ownership, and of course higher housing prices. It was fuelled by low interest rates and large inflows of foreign funds that created easy credit conditions. Between 1997 and 2006 (the peak of the housing bubble), the price of the typical American house increased by 124%. Many research articles confirmed the timeline of the U.S. housing bubble (emerged in 2002 and collapsed in 2006-2007) before the collapse of the subprime mortgage industry. From 1980 to 2001, the ratio of median home prices to median household income (a measure of ability to buy a house) fluctuated from 2.9 to 3.1. In 2004 it rose to 4.0, and by 2006 it hit 4.6. The housing bubble was more pronounced in coastal areas where the ability to build new housing was restricted by geography or land use restrictions. This housing bubble resulted in quite a few homeowners refinancing their homes at lower interest rates, or financing consumer spending by taking out a second mortgage secured by the price appreciation. US household debt as a percentage of annual disposable personal income was 127% at the end of 2007, versus 77% in 1990[2]

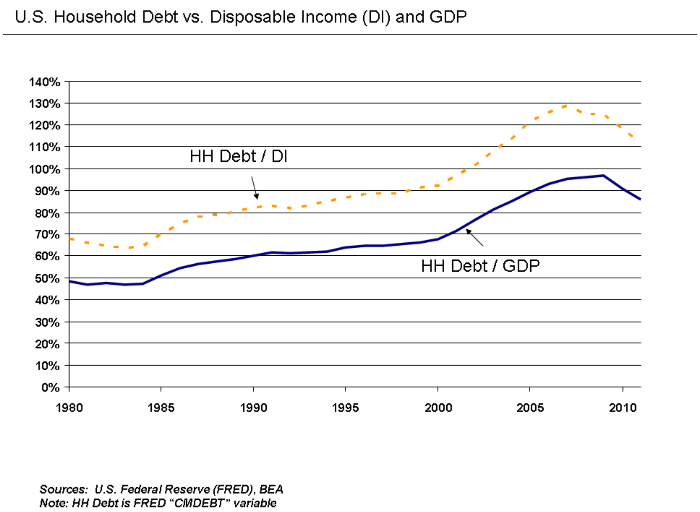

Figure 1.U.S. Household Debt. Vs. Disposable Income (DI) and GDP

With the Federal Reserve raising interest rates several times, the interest rate of mortgage repayment continues to rise, so the subprime mortgage can bring high profits to the lending institutions in most cases. And sometimes they may lose money due to defaults. When the government raises the loan interest rate, the assets purchased by consumers will depreciate, and the liabilities of consumers will increase rapidly. At the same time, consumers' income remains unchanged, consumers with lower credit rating lose the ability to repay loans, and the social default rate is rising [3]. With the decline of house prices and the devaluation of residents' assets, the phenomenon of overdue repayment of subprime mortgages and foreclosure is common. As the purchasing power of society becomes increasingly tight, the payment chain of subprime mortgage is forced to be interrupted, and many small and medium-sized loan institutions are gradually going bankrupt. With the collapse of mortgage institutions, the credit payment chain of the whole society has been interrupted. Many banks operating tape financial products have suffered huge losses or even bankruptcy. The collapse of a large number of financial institutions has caused a high degree of credit tension in European and American countries, leading to the outbreak of the financial crisis. The reason for residents' default lies in the heavy damage from the future expectation and the pessimistic attitude towards the future expectation from the unsustainability of overdraft consumption. From the whole process, the consumption overdraft is to alleviate the problem of enterprise overproduction, which originates from the lack of effective economic demand. The reason for the lack of social effective demand lies in the polarization of capital and labor income distribution. A few people hold most of the wealth of the society, but the effective demand shown by a few people is limited. Therefore, the fundamental contradiction of capitalist society is the contradiction between socialization and privatization. The root cause of all the real crises is the poverty of the masses and the limited consumption, but the poor masses account for most of society. At that time, capitalism could not get rid of the nature of pursuing profits, expanding production regardless of the actual situation, stimulating social demand, and developing into a kind of abnormal society that "it seems that only the absolute consumption power of society is the limit of the development of productive forces".

3. THE CAUSES OF SUBPRIME CRISIS

Marx provides a basic analytical framework for explaining the causes of the economic crisis: the market economic system is the objective basis for the formation of the capitalist economic crisis [4]. The economic crisis is the full development of internal contradictions of commodity economy in the field of macro economy. The basic social contradiction is the institutional root of the capitalist economic crisis. The economic crisis is the overall intensification of the internal contradictions of the capitalist economic system in the field of macro economy. The expansion of the credit economy is the economic crisis of the capitalist economy. It is the concentrated expression of the "demand bubble" in the macroeconomic field.

3.1 The root cause -- the basic contradiction of capitalist mode of production

The private possession of capitalist means of production is the root of the economic crisis. The capitalist mode of possession of means of production leads to long-term income polarization, and the gap between the rich and the poor is large. The middle and low-income class, which accounts for most of the population, has little wealth and income. While the high-income class, which accounts for the minority of the population, has most of the income and wealth of the society. The poor have a strong desire to buy but a weak ability to pay, while the rich have a strong ability to pay but a small effective demand. And after the rich reach a certain class, the original demand will not still have demand, and the effective demand of the rich will change. The gap between the rich and the poor leads to insufficient effective demand, serious overproduction and economic crisis [5]. The sub-prime crisis in 2008 is characterized by fictitious capital surplus, the essence of which is the long-term excess of real capital. The new manifestation of the economic crisis is from overproduction to capital surplus.

3.2 Direct reasons: financial risks are continuously transferred to others

From 2005 to 2007, institutions and individuals over overdraft credit met with virtual capital transactions, and various related financial derivatives and related assets were securitized and then packaged for resale. In the period of economic prosperity, the financial products stimulating loans were warmly sought after by capital due to high profits, and were acquired by financial institutions such as investment banks and hedge funds. The latter obtained funds from traditional banks, insurance companies and other financial institutions and residents, leading to virtual capital, large-scale liquidity and financial market securitization. The essential reason for this phenomenon is that people have a fluke when they face the risk of virtual capital. They want to transfer the risk as soon as possible and move their vitality into their hands. Due to the rapid transfer, the lack of strict review of the transaction bottle and contract links, resulting in the risk explosion. The process of formally or informally shifting the financial consequences of particular risks from one party to another, whereby a household, community, enterprise or State authority will obtain resources from the other party after a disaster occurs, in exchange for ongoing or compensatory social or financial benefits provided to that other party.

3.3 External incentives: financial credit rating distortion and ineffective supervision.

At present, Fitch, S & P and Moody's, the three major U.S. rating agencies, monopolize 90% of the global bond rating market. Of the guaranteed debt securities issued from 2005 to 2007, 85% were rated AAA by S & P, most of which were junk bonds [6]. Although the U.S. Congress passed a bill on the reform of the credit rating system in May 2010, requiring enterprises not to choose their own rating agencies, but to be designated by special government agencies. However, knowing that the rating agencies will not bear the consequences of rating when they want to charge the enterprises, they will "act according to the money". The distortion of financial credit rating, the falsification of commercial credit, the misleading of bond buyers, the disorder of the bond market and the lack of relevant rules and regulations have all become the inducements for the outbreak of the economic crisis in capitalist countries.

3.4 Ideological and theoretical reasons --- believe in liberalism

In the past 30 years, the United States has accelerated the implementation of Neo liberal economy. The so-called new liberalism is a trend of thought that revives traditional liberalism and aims at reducing the government's intervention in the economic society. Neoliberal policies center around economic liberalization, including reductions to trade barriers and other policies meant to increase free trade, deregulation of industry, privatization of state-owned enterprises, reductions in government spending, and monetarism. Neoliberal theory contends that free market encourages economic efficiency, economic growth, and technological innovation. State intervention if aimed at encouraging these phenomena, is generally believed to worsen economic performance.[7]

The new liberalism carries out the privatization and liberalization management of enterprises, lacks the supervision of market system, and is often vulnerable to the test of crisis. When the financial crisis came into being in 2008, the human resources department lacked a regulatory system. In addition, Wall Street investors exploited loopholes in the system to deceive the public. In order to encourage people to consume crazily, the allocation of social resources was seriously unbalanced. The implementation of the new economic policy of the United States indirectly contributed to the outbreak of the subprime crisis.

4. MEASURES TO SOLVE THE SUBPRIME CRISIS

After the subprime mortgage crisis, western countries adopt various ways to deal with the economic crisis. The main measures are the government's policies to support banks and nationalize enterprises.

4.1 Western countries spare no effort to save big companies

In the face of the economic crisis, Western governments first adopt the policy of protecting large enterprises. By January 2009, the latter challenge fell to Obama. It’s true that the economy continued to sink for the first six months of his first term, but, to Bush’s credit, there were no crisis-like shocks after the near-collapse of the major American auto companies in December 2008. Furthermore, it was Bush who decided initially, for good or ill, to save those companies — Treasury made short-term loans to Chrysler and GM that December.[8]

The direct reason is that these large companies have a wide range of design industries and provide more jobs. When large enterprises close down, it will cause a large number of people to lose their jobs, social unrest and national unrest. Roosevelt's new deal in 1935 brought the United States out of the quagmire of the great depression [9]. This series of policies focused on providing jobs for the unemployed and ensuring the safety of the working class. From the deep level, the government's rescue of large companies is due to the consideration of the recovery and development of vehicle models.

4.2 The government adopts various nationalization policies

State owned enterprises have the ability to resist risks and restore their functions. Nationalization has become an important means to solve the economic crisis in western countries. After the financial crisis in 2008, some countries, such as the United States, the United Kingdom, Germany and so on, used state funds to inject funds into enterprises and commercial banks to provide a guarantee, in exchange for the company's controlling interest, to avoid the collapse of enterprises due to capital turnover problems, and to intervene in the rescued enterprises and control risks. In the process of capitalist development, private ownership has always been the main body of all systems, but nationalization is often an important embodiment of the country's response to the economic crisis. No enterprise can be perfect, and any system of enterprises has advantages and disadvantages, so the country needs to combine its own situation to develop the road in line with national conditions.

5. CONCLUSION

The capitalist economic crisis has brought great damage to the operation of the world economy. The essence of capitalist economic crisis lies in the internal contradiction of capitalist system. Through the performance of the American subprime mortgage crisis in 2008, this paper deeply analyses the causes of the capitalist economic crisis and puts forward solutions from the analysis of the causes, to avoid risks and prevent them. It is found that the root cause of the subprime mortgage crisis is the basic contradiction of the capitalist mode of production. The direct cause lies in the transfer of financial risks. The distortion of financial credit rating and weak supervision are the external inducements for the outbreak of the economic crisis. The traditional ideological and theoretical reason is the belief in freedom.

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