The Limitations of Capitalism
and the
Origin of Financial Crises

Part I: The Social Origins of Commodity Capitalism

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In the late 1970s capitalism emerged as the unchallenged economic system in America. It was identified with democracy and progress in the Reagan years and it was championed by economists, journalists and politicians alike. Milton Friedman became its most prominent spokesman and, along with his students at the University of Chicago, it was exported to the Latin America and other countries of the third world. At home, capitalism was enshrined as the best of all possible economic systems and its Marxist critics were relegated to the dustbin of history. By the end of the end of the millennium, capitalism had become so accepted and entrenched in the political debate that to question it was tantamount to treason. Both Republicans and Democrats preached the free market sermon. To fulfill its glorious promise, they agreed, capitalism only needed to be freed of the fetters of regulation. The free market, free enterprise and deregulation, we were told, would solve all our problems and the alternatives were simply unthinkable. But it was all a delusion.

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Events at the end of the first decade of the new millennium have led many to question capitalism's supposed invincibility. Instead of the perfect economic system and a timeless panacea for all social problems that its supporters have claimed for it, capitalism is in reality a fundamentally flawed system that has no special claim to a free market, has economic cycles of recession and expansion built into its structure and ironically bears the seeds of its own eventual collapse. To understand these intrinsic limits of capitalism it is necessary to clarify our definitions and to reexamine the social conditions that created capitalism in the first place and thereby dispel the mythology surrounding it.

The Consumer Production Economy

The earliest production system is the *consumer production economy*. In such economies, the producer of a good or service controls the production of that good or service and is also the primary consumer of what is produced. In such an economy, producers make only what they need and they make it only for themselves. They are self-sufficient. In such systems, the producer and the consumer are the same person. The best example of a society with a consumer production system is a peasant community. Peasants grow food and make tools and commodities primarily for their own use and are, therefore, the ultimate consumers of their own products.

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It is important to note here that *members of consumer production societies also determine on their own what they will produce and how they will produce it*. They are in control of all aspects of production and they decide, for instance, what crops they will grow, how much they will grow or animals they will keep, what tools they will use to grow the crops or animals and how those tools will be made. Naturally, they will be limited in their choices by the weather, the soil and other environmental and social factors but the important point is that they are, in principle, in control of the means and goals of production. No one tells them what to produce or how to produce it.

If the weather is good and they are fortunate to have a surplus or an extra tool that is no longer needed, they can trade it with a neighbor or in the market. However, *trade is an incidental part of the consumer production economy* and is sporadic and seasonal at best. Peasants will have harvest fairs where those lucky to have a surplus can exchange it for something they have otherwise lost, broken or been unable to produce or obtain. In general, trade in consumer production societies occurs intermittently and is not something done on a regular basis.

This trade is accomplished through barter, a *direct exchange* of goods or services, and does not involve the use of an intermediary such as gold, money or some other universal token of value. This creates stability because trade in a consumer production economy is neither necessary nor regular. A peasant may bring an extra chicken to the market to trade for a wheel barrow or spade and that will be the end. If there is no wheelbarrow or spade available to trade or if the peasant with a wheelbarrow wants a goose in exchange and no agreement on an exchange occurs, the peasant will eat the chicken and make do. *Each trade in a consumer production economy is unique and personal*. The important point to note here is that the overall value of chickens will not decrease if this particular trade does not happen nor will the value of wheelbarrows or spades increase because there are none to be had at the moment. Regardless of the outcome of the trade, the value of chickens, wheelbarrows and spades will remain the same for the community as a whole.

The value of commodities in a consumer production society is not affected by trade. This makes consumer production economies very stable but it also keeps them from growing. There is no reason for a peasant to make more shoes, gather more wheat or collect more milk than he can consume or use in an occasional trade. Besides, storage is limited, food tends to spoil and livestock requires care and feeding all of which can negate their value.

Trade and the Decline of the Consumer Production Economy

With the growth and movement of populations and with advances in transportation,[1] markets become regular, long distance trade emerges and local products are gradually augmented and overshadowed by non-local, often exotic items brought in from far off places. These non-local items are usually luxuries because they offer the greatest return. It would not make sense for

[1] The appearance of the camel, the horse and the lateen rigged ship were early improvements in transportation that allowed more goods to be carried and for longer distances. This led to larger and more regular markets which in turn led to the growth of towns around those markets. The increase in the number of towns gave more opportunity for trade and provided places to resupply the caravans and ships which, in turn, increased trade.

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merchants to transport heavy sacks of flour for hundreds of miles because the expense of feeding animals to carry such a load and the length of time it would take to bring them to a distant market would not be worthwhile. Besides, unless there was a famine in the region, there would be local sources of flour or some similar staple which would keep the price to a minimum and make long distance trade unprofitable. On the other hand, small, light-weight luxury items would be cheaper and easier to transport and be in much higher demand in a market where those goods are not normally available. Among those luxury items historically are silk cloth, furs, bronze weapons, jewelry, spices and especially incense.[2]

However, as markets grow to include ever wider trading networks, they transform the nature of the consumer production economy. To be able to acquire the growing variety of new items available in the marketplace, the participants must have something to trade. Since a peasant cannot sell what he produces for his own needs he must *break out of the limits of consumer production and produce a deliberate surplus* which would then be available for trade in the market. Very simply this means growing more grain, raising more livestock or making more leather goods than needed. Increased trade brings merchants who need food for themselves and feed for their animals and will gladly trade for those. At the same time, a growing population would force some members of the peasant community to leave their overburdened communities and either take to the road or move into a nearby town. Such towns would need food and that would add to the demand.

Once the peasant stops being the primary consumer of what he produces and stops producing all that he needs, he is no longer independent of the market

In order to produce more than is required for himself and his family, the peasant needs to work longer hours, acquire more land, hire on help or engage machinery.[3] Alternatively, the peasant could *limit the variety* of the things he produces and concentrate on fewer or only one product. Instead of making both his own tools and growing his own food, the peasant might spend all his time growing only food and trade for the tools or grow only wheat and trade for milk. In extreme instances, the peasant could also produce a commodity or service for which he himself has no use but which has value in the growing market.

Once the peasant stops being the primary consumer of what he produces and stops producing all that he needs, he is no longer independent of the market. He must now rely on the market for those missing products. At the same time, the peasant now produces a surplus or a commodity that has no intrinsic value to him or to his society but does have value for strangers in the marketplace. Thus, both surplus production and specialized production gradually undermine the fabric of the traditional peasant community. Trade and the market now become the center of economic life rather than the periphery and the close ties that once bound members of the consumer production society together begin to unravel. Where before the members of such

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[2] Silk traveled across the famed Silk Road from China to Europe on camelback, pepper came from India but the most valuable commodity was balsam from Palestine and frankincense and myrrh from Arabia. So much incense was imported into the Roman Empire that it created a severe drain in its silver supply at an estimated 15 million florin per year. The merchant families who controlled this trade became immensely wealthy.

[3] The most prominent example of early machinery is the mill and every late medieval village had at least one.

societies worked as a community and came to each other's aid, now they become competitors in the market. A peasant in need can no longer rely on help from his neighbors and will be forced to sell part or all of his land and put himself out as a laborer.

As a result, land and wealth become concentrated into fewer hands, a pool of landless peasants emerges and *labor now becomes a commodity in the marketplace*. Many of these landless peasants will drift into the emerging towns where they will increase the demand for food and clothing. Towns can supply neither on their own and require a market to provide these commodities. Thus, towns and markets become synonymous. And because towns are centered on markets, they become the power base for a new class, one that does not produce commodities but bases its wealth solely on the sale of commodities. Unlike a member of a consumer production society who produces what he consumes, the trader sells what others produce but produces nothing himself. As a result, the urban market becomes increasingly a one-way market. Instead of trading a bag of wheat or loaf of bread for a chicken as in barter, urban traders sell their goods for a universal commodity that transcends all markets. This universal commodity is money.

A Brief Digression on the Emergence of Money

As trade expands barter becomes increasingly cumbersome and is replaced by a universal means of exchange. The first such as universal means is gold. This, in turn, accelerates the unequal distribution of wealth that accompanies the decline of the consumer production economy. Wealth disparity in a peasant community is originally limited. A peasant can own just so many tools or sheep or land before it is beyond his ability to use or maintain them. But gold is easily accumulated, stored and converted and requires no maintenance. Gold does not need to be fed and it does not spoil so there is no limit to how much one can accumulate. Gold is also more portable than most commodities and can be easily transported and removed from the community where it is created. In addition, the ability to store gold as well as its relative ease of mobility gives it the ability to transfer demand through time and space. In other words, gold can be spent at a time and place of the holder's discretion and, as a result, it is no longer tied to the life of the community. In that sense, the advent of gold as the preferred standard of exchange is one more nail in the coffin of the consumer production community.

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But gold has problems of its own. In barter, the products to be exchanged are readily recognizable and need little or no verification. Gold, on the other hand, needs to be weighed and its purity and value must be verified for each transaction. This takes time and makes large scale trade cumbersome. To overcome this problem, gold is standardized and replaced by coins of a given value. Coins are less bulky than gold and because their value is set and constant they do not have to be weighed to establish their worth. A coin's value is a given and is immediately determined by its shape and design. In short, handing over two florins in a transaction is much simpler and easier than handing over a sack of gold which needs to be weighed by an acceptable scale to determine its value.

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But coins also have problems. Although they ostensibly contain a uniform amount of pure gold, coins can be clipped, shaved[4] and debased. They also gradually wear down through simple use. The result is that coins can lose their value but the way this happens will have major repercussions for the future of the economy. Since a coin's face value is set as its gold content depreciates, it will now take more coins to buy the same commodity. A loaf of bread that cost a florin will eventually cost two florins. Thus, coins lead invariably to *inflation*.

Prior to the advent of coins, exchange value is difficult to manipulate. In a barter economy, for instance, a chicken is worth a chicken and in a market economy an ounce of gold is worth an ounce of gold. Values do not change except in times of extreme adversity such as war and bad weather when certain goods such as food are scarce and more valuable. But prices return to their old values as soon as the disruption ends and inflation never takes root. However, a coin worth one florin is still worth one florin even after its gold content is reduced. But since there are now more florins in circulation, their exchange value eventually diminishes. Therefore, over time, it will take more florins to purchase the same amount of goods.

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The result is an increase in prices but this time that increase does not go away. Unlike price shifts in a consumer production society, when prices rise in a money economy they do not return to their old values unless there is a major social collapse. But at the same time, prices do not rise continuously either. Devaluation leads to higher prices but once a new equilibrium is achieved prices stabilize. Thus, the advent of coins is invariably accompanied by periodic but discontinuous inflation.

The introduction of coins transforms the nature of the state as well. In fact, the state owes much of its existence to a coin based economy. Before money, taxation was difficult to implement because it was paid in kind, that is with commodities like grain or livestock or with labor. Neither was easily transported or stored.[5] Coins are a boon for governments because they don't have these limitations. At the same time, they allow for deliberate devaluation. Governments in debt can call in coins and reissue them with lesser gold content but the same value. This allows governments to pay off the large debts incurred to outfit armies and administrative staff needed to retain power.

The Birth and Consequences of Capitalism

[4] Isaac Newton devised the method of adding ribbing to the perimeter of a coin so that any attempt to shave it could be easily detected.

[5] Before money, taxes were collected in kind and involved the transportation of bulky commodities such as grain and livestock that were not only time consuming to gather but also required special storage facilities and maintenance. Money not only made taxation easier and more reliable, it also eliminated the storage problems and made it easy for states to increase taxes or impose new ones.

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The new economic system that replaces the consumer production society is a *market production* society. Where members of the consumer production society produced for themselves and controlled the means of production, members of market production societies produce for the market. This market production society is better known as *capitalism* and it differs from the previous consumer production economy in several distinct and critical ways.

The first and most defining feature of capitalism is the *separation of the control of the means of production from the manipulation of the means of production*. By hiring workers to produce identical commodities at the fastest speed in order to compete with other capitalists, the workers are no longer able to control the conditions of their labor. This is made even more pronounced with the advent of machines. Historically machines appeared first in the textile industry with the spinning jenny and from them on, the pace and details of production were lost to the worker. As capitalism separates the control of the means of production from the manipulation of the means of production it pits the capitalists against their workers and produces class conflict.

Capitalism is a process, a means without an end and as such it cannot stop, it can only be stopped.

As we have seen, unlike members of a consumer production society, a capitalist produces commodities not for his own consumption but for the consumption of others. But this leads to a problem. When has the capitalist produced enough? Remember that the peasant only produces what he needs and only produces as much as he needs. When a peasant sows enough seed to get him through the winter, he stops. When he makes the tools he needs, he stops. But a capitalist has no such limits. A capitalist produces for others and not himself and therefore he does not know how much to produce or when to stop producing. A capitalist *produces for a market* and what he produces is *determined by that market*. Consequently, a capitalist continues to produce a commodity until the market becomes saturated and the value of the commodity becomes less than the cost to produce it.

This is an important point and requires elaboration. In capitalism, commodities are produced to sell in the market and they are produced until the market can no longer absorb them. At that point the capitalist stops producing or produces something else. Because capitalism has no direction or goal its practitioners rally around the idea of *growth*. Capitalism brings growth, they claim, but no it is never specified what kind of growth. All things grow including tumors. Growth without an end or purpose is growth without limitations. In medical terminology, this defines a cancer.

There is no “end” or goal built into the capitalist process as there is in the consumer production economy[6]. A peasant who produces for himself stops when he has all he needs but a capitalist has no such brakes. A capitalist produces until the market is saturated. At that point he stops and, unfortunately, so does the economy. The outcome is an economic system that moves in fits and

[6] The first capitalist associations retained some of the values of consumer production societies and did have a goal. They were either family centered and had a family goal (i.e. the Medicis or the Fuggers) or they were a lose collection of traders trying to limit their risk by splitting the investment (i.e. the Plymouth Company or the East India Company). In the latter case, the traders required the permission of the monarchy and would receive a charter defining their purpose and a time limit to achieve it.

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starts. Commodities are produced for the market until they exceed the market's capability. Then the production stops to wait for the market to catch up. During those stops in production, workers are idled and the economy slows. This is inevitable and it is one of the reasons for economic cycles under capitalism. They are not an accidental outcome of some mystical interaction of supply and demand or of bad management or greed but an intrinsic feature of the capitalist economic system. Incompetence and greed can aggravate them but, in the end, *recessions and expansions are an inevitable feature of a market production society*.

This pattern of recession and expansion is compounded by another feature of capitalism. Because the capitalist takes a profit from the sale of his commodities, the workers are never paid the full value of their product. That means that the workers cannot purchase what they have created with the wages they are given. As a result, the demand for all commodities in a capitalist society cannot keep pace with the prices in the market and once again the capitalist must halt production and wait for the market to catch up. This means worker layoffs and another economic cycle. The only way to avoid this is to find new markets. Colonialism was one way to achieve this, the creation of credit was another. Both have limits. Once all the markets have been tapped, capitalism will collapse. How far and how deep this collapse will be will depend on how far capitalism is allowed to grow without oversight and control.

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The pattern of recession and expansion also has another disquieting feature. It allows for a growing disparity in wealth and power. Whenever a recession occurs, some capitalists are affected more than others. Depending on the nature of the commodities produced, a few capitalists may even prosper during a downturn. In any event, there will always be some capitalists who retain their wealth and are able to buy out those who do not. These fortunate capitalists will fuel a new expansion and emerge from the recession wealthier and more powerful than they began. These surviving capitalists also use the recession to streamline their production processes with technological innovation which usually means that fewer workers need to be rehired. In the long run this means that recoveries will become increasingly jobless.

Thus, like the Phoenix of mythology, all recessions contain within them the seeds of a new expansion. And when that expansion occurs, the capitalists rally to denounce their critics claiming that the recession was due to outside factors and after a brief adjustment the system is back and functioning fine. But in reality, the recession is built into the very fabric of capitalism and cannot be avoided without political intervention. In fact, the recovery only sets the stage for another recession down the road. Capitalist apologists will work to give the impression that recessions are the result of outside interference in the market and that they are not really all bad. After all, they are good for somebody and they allow the system to weed out inefficiency. But this is only a half truth and a misstated one at that because, in the long run, each capitalist recession will concentrate wealth into fewer and fewer hands. The rich will get richer and the poor will get poorer. And as the number of poor

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increases there will be fewer and fewer able to purchase the commodities in the market. When the whole world and every corner of it are brought into the system, there will be no new markets to save capitalism. The system will then grind down once again but this time without a recovery.

Another new feature that is unique to the capitalist economy is *competition*. In a consumer production society where everyone produces for himself, competition is pointless. One cannot compete with oneself. In addition, since everyone's survival is intimately tied to everyone else in the community, the emphasis is on cooperation. In capitalism, this is no longer the case. The one who gets the most to the market the fastest will make the most money and those that lag behind may not be able to weather the periodic and unavoidable recessions.

In order for a capitalist to be the first with the most in the market, he must out-produce the competition. This involves either bringing trade goods as quickly to market at possible by using the fastest transportation and shortest route available or preventing competitors from using them. But trade in quantity has limitations and another way is needed to produce more commodities. Thus, capitalism gradually shifts to producing its own commodities directly for the market. It does this by employing the legions of disposed peasants and craftsmen unleashed by the decline of the consumer production society. This is the origin of factories by way of the "putting out" system or cottage industry.

Each recession ends with a decline in the use of labor in order to control costs. Recessions allow mechanization and technology to be introduced into the production process because labor under these conditions is too weak to resist it. The problem of capitalism is that competition eventually diminishes profits. To overcome this, capitalists become monopolies. However, if that is not possible, commodities have to be made more cheaply and demand has to be augmented to purchase those commodities. But there is a limit to how cheap something can be made so the capitalist turns the only thing left to cut back—labor.

Eventually the markets will run out and then capitalism must collapse under the weight of its own limitations.

At first, guilds and unions are broken and wages are controlled. Next, unemployment is deliberately kept high to keep wages down and cheaper labor sources are sought whenever possible. Foreign workers are brought in to compete with local labor and when that runs its course work is outsourced to areas with lower wages. Because capitalism is a means without an end, there is always a need for new markets to absorb the accumulated commodities that cannot be purchased at home. But every new market eventually encounters the same problem as the old one and the process must go on.

A final word on the concept of markets. As this brief overview has shown, markets are present in *both* capitalist and non-capitalist societies. *Free markets* are those in which the participants are equals and unable to control either supply or price. Once certain participants are able to dominate the market because they are either more powerful or wealthy than other participants, the market is no longer free. *Controlled markets* can be found in both capitalist and non-capitalist (i.e. socialist) societies but they are much more likely in the former. The idea that capitalism is synonymous with the free market is simply false. To the contrary, a capitalist needs to *control*

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the market to survive. This will eventually lead to the creation of monopolies, cartels and advertising and a new variation called financial capitalism.

A major intent of this essay was to show that capitalism is not the panacea for all ills that it proponents claim but a socially and historically bound economic system that has serious internal flaws. While it created a great deal of wealth and comfort for twentieth century citizens from better sanitation to faster transport to increased food production and better health these improvements were largely confined to Americans and Europeans.

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For other societies, capitalism has been a source of misery and oppression. It caused tremendous upheaval to the consumer production society it displaced and it came with a set of internal contradictions that bring us continual economic cycles, labor conflicts and a growing disparity in the distribution of wealth. As markets close down and commodities decline in importance, the old version of capitalism centered on commodities becomes distorted and unworkable and a new version centered on money and credit, *financial capitalism*, moves in to take its place. But financial capitalism solves none of capital's central problems and adds several of its own. The discussion of these problems and changes along with specific examples from American economic history will be the subject of Part II of this essay.

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