12-1977

The Roots of Current Economic Problems

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Since the middle 1960s the American economy has not performed well. The past decade has witnessed nascent financial crises, unprecedented inflation, chronic and escalating unemployment, a rapidly depreciating dollar, urban deterioration, a "lost" generation of ghetto youth, and traumatic defeats in two wars; one in Vietnam and the other on poverty. This decade differs greatly from the two decades of relative tranquility that followed World War II.

These turbulent years are the equivalent of a critical experiment which tests the validity of a theory. The standard economic theory of our time, the neoclassical synthesis, does not explain how our economy can transit from tranquility to turbulence and cannot formulate rules of behavior or be used as a guide to policy for a turbulent economy. The erratic and ineffective course of economic policy over the past decade shows that our policy establishment does not understand our economy. The economic theory they use, the neoclassical synthesis, has failed the critical test.

In order to properly prescribe for an economy it is necessary to understand how it behaves. Today's standard economic theory, the neoclassical synthesis, comes in two packages: An austere Monetarism that originiated in Chicago, and a superficially complex but intellectually banal Econometric Keynesianism that is produced by a number of shops along a Brookings-Cambridge axis. Both Monetarism and Keynesianism are not able to explain the emergence of turbulence — the neoclassical synthesis abstracts from the existence of capital assets and ignores financial relations. Capital asset pricing and the evolution of financial relations are critical in the transition to and the perpetuation of economic turbulence.

family housing, Social Security, Unemployment Insurance, Minimum Wages, Agricultural price supports, soft anti-trust policies, unions legitimized by government, and commissions to regulate various markets are but part of the institutional structure that was either created or radically modified during this period. The basic structure of our economy was created during a great depression that followed a series of financial crises which the dominant academic economic theory of the day was not able to explain. In good part the economic reforms aimed to establish institutions which would prevent the occurrence of another depression.

It is important to keep dates in mind. Roosevelt's first term began in March 1933. The main economic reforms were completed by the mid-term election of 1938. Keynes' preface to *The General Theory . . .* is dated December 13, 1935. It was published in England in the Spring of 1936. The major academic reviews appeared in 1937. Great as the impact of *The General Theory . . .* may have been, it is clear that it could not have influenced the economic reforms of 1933-38. Furthermore, the budget deficits of the early 1930s were not the conscious product of policy aimed at increasing employment and income, the motivation was humanitarian (no one was to starve), and the form spending took (Works Project Administration, Civilian Conservation Corps, and National Youth Administration) reflected an abhorrence of a dole (today's transfer payments) as demeaning to the citizen recipient.

The structure of our economy has its roots in pre-Keynesian views as to the causes of the great depression. These views focused on the creation of an unstable debt structure during the protracted expansion which made the economy susceptible to a wage-price-debt deflation. In the 1930s the depression following 1929 was viewed as but another of a series of depressions and financial crises that had occurred in the years between the Civil War and World War I. A main

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Policy cannot be any better or more relevant than the theory of the policy advisers allows. As long as the policy advising is dominated by Monetarists or Econometric Keynesians, policy will be unable to cope with our economy. When the economists who advise officials do not understand our economy, the political authorities cannot govern wisely.

Neoclassical economic theory abstracts from institutions and ignores history. Economic policy is not made for a mathematical or statistical abstraction; policy is made for our economy which evolves in calendar time, has a history that breeds uncertainty about the future, and whose institutions were largely created by legislation in response to situations that are long past and scarcely remembered. Our institutions reflect the interplay of perceptions of economic problems and theories of how our economy behaves with historical power and interest relations: Economic perceptions, economic theory and politics created the institutions which evolved into the structure that is today's economy. Not only are "Practical men . . . usually the slaves of some defunct economist . . . " [J.M. Keynes, *The General Theory . . .* , p. 383] but economic institutions are embodiments of the ideas that were held by politicians and their economist aides when the institutions first emerged.

Our institutional structure is mainly a legacy of the first years that Roosevelt served as President. Deposit insurance, the commercial and central banking structure, the subvention and support of single-

object of policy in the 1930s was to erect institutional barriers to debt financing and debt-deflation. In addition to banking reforms such as deposit insurance, a major thrust of the reforms was the creation of institutions and usages that acted as barriers to downward pressures on wages and prices.

The main object of the first New Deal — that of the National Recovery Administration — was to raise prices in order to ease the burden of debts inherited from the 1920s. When N.R.A. collapsed, alternative institutions — such as minimum wage legislation, trade unions, agricultural price supports and a soft anti-trust policy — were introduced to act as barriers to price deflation.

During World War II the power of big government to expand the economy became evident. Because of the Cold War and the explosion of transfer payment schemes, government has remained big. During the 1960s the conscious use of fiscal and monetary policy to guide the economy won political acceptance. However, what was accepted was a "Conservative" version of Keynes' teaching. Government, under the cover of inducing growth, became an instrument, through tax and incentive schemes aimed at increasing investment, thus, inadvertantly increasing instability and inequality. The conservative Keynesianism of Kennedy, Johnson and Heller served to accelerate the thrust towards financial instability, which has plagued us in the past decade.

As the 1960s progressed it became apparent that when orthodox Keynesian fiscal policy is used within the economic framework inherited from Roosevelt, a closer approximation to full employment than hitherto can be achieved and sustained. In the 1970s it has become apparent that the combination of an active fiscal policy, such as emerged from the Kennedy-Johnson years, and our institutional structure, that is a legacy of the Roosevelt era, gives rise to speculative financial practices that regularly lead the economy to the brink of a financial crisis. Big government makes massive government deficits a normal event in the recession that follows a near miss financial crisis. These huge deficits make a serious debt deflation impossible. A deficit sustains income, assures that business cash flows are sustained so that debt can be validated, and feeds safe and marketable financial instruments into balance sheets. Even though the economy is unstable, a cumulative downward movement as in 1929-33 cannot take place. Inasmuch as government deficits during times of rising unemployment increase disposable income relative to the available supply of consumer goods, increases in unemployment are accompanied by an increase in prices. "Slumpflation" is a product of a financially unstable economy in which big government aborts the thrust toward a debt deflation and an institutional structure that is the legacy of an attempt to prevent debt deflations in an economy in which government is small.

We now have a turbulent economy that is financially unstable and burdened by domestic and foreign debts. It is not behaving the way it is "supposed to." The first step toward achieving policies that can improve the behavior of the economy is to relegate neoclassical theory to the dust bin of intellectual history. Only a theory which makes financial instability a normal functioning result of the capitalistic process and normal path of the economy, can help us to do better. Out of *The General Theory . . .* a theory of the capitalist process that is relevant for our type of economy can be derived. This financial Keynesianism is different from what passes as Keynesianism in today's common discourse and it leads to policy prescriptions that differ from the conventional prescription.

Policy has two dimensions: one is institutional reform, the other consists of operations within a fixed institutional framework. One conclusion from financial Keynesianism is that much of the Roosevelt legacy can and should be dismantled. A simple set of employment-creating organizations — WPA, CCC and NYA may be considered as prototypes — should become the cornerstone of economic policy. The emphasis upon growth in policy should be replaced by an emphasis upon employment. The inducements to invest and the barriers to employment in the tax system should be eliminated. Anti-trust policies should be hard — with limitations imposed upon the size of assets managed by both financial and non-financial organizations.

Partial trade unionism, which we now have, is one of our engines of inflation and is an integral part of our soft anti-trust policies (General Motors needs the U.A.W. as protection against effective anti-trust policies). Partial trade unionism should be replaced by comprehensive trade unionism which, by its very nature, becomes a vehicle for incomes policy. Furthermore, for those parts of the economy where the government is a large buyer of output or payer for services, government "monopsony" power must be exercised for wage and price stability.

This is not the place nor do I have the time to go over all the dimensions of our current institutional structures which tend to aggravate the inherent instability of sophisticated capitalism. I believe the Roosevelt reforms served us rather well, but in the world in which we now live, and in the light of our current understandings of how an economy works, they stand in the way of the effective progressive and humane society that the Roosevelt reforms tried to achieve. Policy must move beyond manipulation within our institutional structure and forward to another creative era of institutional reform.

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