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Finance and Stability: The Limits of Capitalism

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The Limits of Capitalism

by
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I participated in a Conference on Financing Prosperity in the 21st Century at the Jerome Levy Economics Institute of Bard College on March 4, 5, and 6 1993. March 4 was the 60th anniversary of the inauguration of Franklin D. Roosevelt as President of the United States and March 6 was the 60th anniversary of the bank holiday in the United States.

The problems Roosevelt faced sixty years ago and the problems confronting President Clinton resonate. Roosevelt inherited a failed capitalism and a new model capitalism was put in place during his first term (1933-1937). Roosevelt's new model served the United States, and the world, well for almost half a century.

Over the past dozen or so years the 1933-1937 model has shown its age. Although it has not broken down as completely as the older laissez-faire model had over the 1929-33 period, quite clearly our current model of capitalism needs to be at least thoroughly overhauled if not replaced. Whether he realizes it or not, the historic task of President Clinton is to discover and put in place a new model capitalism.

The usual description of the 1933 bank holiday is "Roosevelt closed the banks." This is not true. By March 4th 1933 the banks in some 30 states had been closed by the Governors of the states. On Saturday March 4, as Roosevelt was being inaugurated he was informed that the New York

Even as we celebrate the "victory" of capitalism we are aware of the current problems and crises of the once very successful post war capitalisms. While the capitalisms of the United States and Western Europe were truly successful societies during the first two and a half decades after the second world war, their performance over the last decade and a half falls short of the standard achieved earlier. Japan, which seemed to have escaped many of the problems besetting the United States and Western Europe in the past decade, now seems to be catching up. We add two questions to our list:

4) "What attenuated the success of the early post war capitalism?"

5) "Why are the welfare states of the post war world now in crisis?"

One reason capitalism won and the Soviet version of socialism lost was that the Lenin-Stalin version of socialism allowed for only one form, the highly centralized linear command model, whereas, as the call for this conference recognizes, capitalism comes in many forms.[3] The successful capitalisms of the 1950's through the 1970's were not the same as the capitalisms that failed in the 1930's. In general a system which we can characterize as a small government gold standard constrained laissez-faire capitalism was replaced by a big government flexible central

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3. At one time the slogan of the Heinz pickle and ketchup company was "57 Varieties". When I make the point about the varieties of capitalism In America, I often say that "There are as many varieties of Capitalism as Heinz has of pickles."

finance.[4] The operations of the publicly traded corporations and the markets in which the trading took place were to be transparent. In addition the Federal Reserve was reorganized in quite fundamental ways.

The financial institutions of the post 1936 era differed markedly from that which broke down between 1929 and 1933. This system once in place began to evolve in response to the profit seeking efforts of the various institutions: any institutional structure which sets limits to the behavior of economic units will set off actions designed to evade or avoid the limits. Furthermore technological changes will impinge upon units in the financial structure in quite varied ways. As a result even though the Roosevelt structure remained in place, the details of financial operations and institutions changed. In particular households, firms, government units as well as financial institutions learned how the system worked and adapted their behavior to best exploit the changing financial environment. These changes led the greater use of debt relative to internal finance as well as the use of debt to acquire existing assets. As a result the once robust financial system became increasingly fragile. As fragility

4. The public infusion of equity took the form of the RFC acquiring a special issue of preferred stock. The RFC did not hesitate to exercise its power by replacing managements that were deemed to be weak. As recovery took place and the banks, railroads and ordinary businesses that had been refinanced by the RFC made profits they purchased or retired the preferred stock issues. See Jessie Jones "50 Billion Dollars"

experience of 1980's, when the lot of those at the bottom either deteriorated or stagnated even though aggregate income presumably rose. It seems clear that capitalisms can function in different ways and that preference systems and the technical conditions of production do not lead to a "law of distribution."

If capitalisms are to be successful in the 21st century they are likely to be quite different from the models we are familiar with. Now that Roosevelt's new model of capitalism has shown that Kennedy's aphorism can be true, the ends that a successful economy needs to achieve includes a wide distribution of the fruits of prosperity than was achieved over extended periods of time by the old model capitalism. Reagan and Thatcher tried to overthrow the big government interventionist capitalisms that they inherited. In the United States the major substantive changes in the economy of the Reagan years were 1) the destruction of the revenue system, 2) the emergence of an economy that was structurally dependent upon the government's deficit financing of a budget that was mainly devoted to military spending and to supporting consumption, 3) the fall in the real wage of a large portion of the labor force and 4) a rising tide of un and under employment.

After a spurious prosperity, largely based upon 1) an unproductive government deficit, 2) an enormous expansion of the financial services industry and 3) Ponzi financing schemes that left the country with an excess supply of characteristics of capitalism. I will also address the question of what turned the failed system into at least a transitory success.

One striking flaw of capitalism - which was identified by Marx and Keynes - is its inability to maintain a close approximation to full employment over extended periods of time. Keynes recognized that capitalism is not merely a market economy: it is also a financial system. A fundamental aspect of the capitalism of Keynes' time and ours is that there are *two* sets of prices. One set consists of the prices of current output and the other set consists of the prices of assets, both the capital assets used by firms in production and the financial instruments that firms issue in order to gain control of the fixed and working capital they need.[5] The price of current output carries profits and is the mechanism by which costs are recovered. In the abstract these prices are keyed to the money wage rate. The price of capital assets and financial instruments are present prices for future streams of incomes. As these two sets of prices reflect what happens in two different sets of markets they will vary independently.

The financial instruments issued by firms are held by households and financial institutions such as banks.[6] Ever

5. See Hyman P. Minsky, John Maynard Keynes, Columbia University Press, 1975 and Stabilizing an Unstable Economy, Yale University Press 1986.
6. In a modern economy household and government debts exist and are held by financial institutions and directly by households. These other liabilities complicate the cash flows and offer routes which can dampen and amplify the

As a result of the security market reforms of the Roosevelt era the law caught up with the fact that modern capitalism is corporate capitalism.

Over the more than 40 months of the great contraction the price level of current output fell by 33% whereas the price level of equities on the stock exchanges fell by 85%. In 1933 it would cost 67% of the 1929 price to produce investment output but it would only cost 15% of the 1929 price to purchase a firm on the stock exchange. Similar ratios held for commercial buildings such as office towers. If the ratio of the prices of old and new capital assets was greater than 1 to 1 before 1929, in 1933 the ratio of old to new was 1 to 4. In 1933 no one would order new investment output when the second hand market for investment, the market for capital assets, was full of bargains.

In standard economic theory prices are the terms upon which alternative goods and services are available. As the theory is set up all that really matters are relative prices. However to producers in a capitalist economy output prices recapture wage and material costs and carry profits. Profits enable a firm to pay the interest and principle that is due on debts, and to provide funds for dividends and retained earnings. Inasmuch as debts are almost always denominated in money, to producers nominal prices matter. In the markets where assets, financial and real, are traded the prices are the present money price of future money

In a modern rich capitalist economy corporations are the proximate owners and the actual operators of the non-housing, non-agricultural capital stock of the economy and the principal purchasers of investment output: corporations are also the principal proximate recipients of capital income or gross profits.

A capitalist economy can be viewed as a set of interrelated balance sheets and income statements. There are two ultimates in this formalization: firms, which own the capital stock of the economy, and households, which own the financial liabilities of other units as assets. Financial institutions stand between firms and households. Today to a large extent the liabilities (equities and debts) of firms are owned by financial intermediaries of one type or another and the assets of households are largely liabilities of financial intermediaries.

These intermediaries - banks, savings institutions, insurance companies, mutual funds and pension funds to identify the most prominent financial intermediaries - are self, or profit, seeking institutions. In a modern capitalist economy maximizing behavior is not restricted to households and firms that own capital assets, for the entire array of financial intermediaries seeks profits. Each profit seeking financial intermediary has an agenda of its own: they are not charitable institutions.

Of these profit seeking private agenda financial organizations one set plays an exceptionally delicate role price of the investment output, with a margin of safety that allows for the riskiness of the project.

One consequence of the introduction of these layers of profit seeking organizations in the markets which determine the value of financial instruments is that the value of financial instruments and therefor the value imputed to capital assets can and does vary independently of the cost of investment outputs. Furthermore the extent to which internal funds are available to finance investment depends upon the excess of anticipated cash flows from operations over the amount needed to service liabilities that were issued to finance such acquisitions in the past.

Because the capitalization rate depends upon present views of the future and the value of the secure assets in portfolios, the ratio of market price of capital in firms to the market price of investment outputs can vary. The very structuring of the argument in terms of a demand for investment output that depends upon the capitalizing of future profits and the determination of the supply price of outputs as dependent upon labor costs of producing these outputs assures that the supply and the demand relations would not, in economist jargon, be homogeneous of degree zero in either money or in money wages. The result would also not be independent of the extent to which positions of market power are capitalized into the price level of capital assets.

financial system affects the prices and demands of outputs and assets, so that from time to time debts and debt servicing rise relative to incomes so that conditions conducive to financial crises are endogenously generated. Such a crisis, if not contained by a combination of Central Bank lender of last resort interventions, which sustain asset prices, and government deficits, which sustain profits, leads first to a collapse of investment and then to a long lasting depression accompanied by mass unemployment.[9] This financial flaw cannot be eradicated from the corporate form of market capitalism, in which liabilities exist that are prior commitments of the gross nominal profit flows of corporations. Reforms which constrain the possibility of using excessive debts for specified purposes were part of the new model capitalism of the 1930's. Many aspects of these constraints were relaxed by the 1980's, especially critical constraints upon the assets eligible for the portfolios of the Savings and Loan Associations were relaxed. The result was a series of crises of financial institutions and corporate indebtedness. A big depression did not happen in the early 1990's because the government validated the debts of the financial institutions that became insolvent and the huge government deficits sustained profits.[10]

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9. In this view the intervention by a deposit insurance authority to assure that deposits at "protected institutions" are paid at par is a central banking action.
10. This validation has been called a bail out.

lead to a sharp decline in the ability to validate debts and therefor to a sharp fall in the value of capital assets as collected in firms remained.

The recent history of the United States is a history of a thrust towards a debt deflation that was contained by a combination of central bank intervention and massive government deficits. The contained depression of the early 1990's ultimately led to a sharp fall in first short term interest rates that, with a lag, is being followed by a fall in longer term interest rates.[11] This fall in interest rates led to a rise in the present values of income streams: Asset values increased and as a result the turbulence in financial markets in the United States has abated.

The capitalism that failed over 1929-33 was a small government constrained Central Bank essentially laissez-faire economy. The capitalism that had a good run after the second world war was a big government interventionist economy with central banks that were less constrained than during the inter war years.

The post World War II model of capitalism was so successful over the first twenty plus years after the War that some are given to calling that period a Golden Age. While in truth it was not a utopian Golden Age, each of us can find fault with some details of the economy of the

11. S Jay and David Levy "How to Restore Long-Term Prosperity in the United States and Overcome the Contained Depression of the 1990's", The Jerome Levy Economics Institute, Annandale-on-Hudson, New York 12504

this would increase the labor force. Therefor there is a need to increase the number of available jobs.

Another problem of the welfare state in the United States is with what is called welfare in the United States. This system, Aid to Families with Dependent Children (AFDC), provides cash and in kind (medical care, housing and food subsidies) support to families with children, if income from work or assets is not able to support the children. In practice a significant part of the population that is welfare dependent is seemingly locked into a pattern of dependency: women who themselves were illegitimate and recipients of AFDC having children on AFDC. This welfare problem is increasingly viewed as a disaster in terms of the well being of the recipients. However the alternative to welfare is work for the mother and child care for the children.

Welfare reform leads to a similar problem as social security reform. Having people now on welfare or on Social Security enter the labor force increases the demand for jobs. The problems of the welfare state in the United States stem from the inability to achieve and sustain a tight full employment without triggering inflation.
We now live in a world where less than 3% of the United States' labor force is in agriculture and where an ever decreasing percentage of workers can produce all of the standard manufactured goods that the economy demands. There is a need to support more workers in the production of

The newly revealed vulnerability of corporations means that the private pension and health care systems of the post war period are no longer viable. The Clinton administration is attacking the problems of our health care system. As yet there is no serious attack on the problems of the pension system that supplements Social Security.

The Clinton administration is a repudiation of the economics and the social policies of the Reagan-Bush years. It accepts that there are government functions which are legacies of the past which need to be cut if not eliminated. There is also a recognition that programs like welfare, social security and health care require reformulation. A big issue as yet not addressed is how is the United States going to administer the industrial policy which up to now has been carried in the military budget.

The United States still has an unrivaled resource in the depth and wide distribution of research universities. Many of these state universities have strong applied research interests, usually in fields that are closely related to the state's economy. The harnessing of the power to create and innovate of such universities and the transformation of the development arms of the defense department into a civilian advanced project agency are frontiers that the Clinton Administration will have to address as they fully develop what they mean by industrial policy.

exists to recognize that the logic of a consumption tax requires that the fair rental value of owner occupied housing enter into the base used for the calculation of the tax. However a thorough and logical consumption based tax system would simultaneously reintroduce meaningful progression into the tax system and cut through the confusions relating to pension schemes. As was mentioned earlier, pensions are a policy problem due to the American system of a government Social Security system supplemented by private pension schemes, which are publicly supported by the way taxable income of corporations and households are calculated.

The Clinton Administration is in a tentative way trying to discover the contours of a new model of capitalism: I don't think it is a conscious quest as yet. But as one item in the menu of unmet needs leads to another a new model will emerge which is more explicit in the partnership of public and private agencies in the development of resources than anything we have had in the United States to date.

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