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Agenda for Monetary Concerns

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Agenda for Monetary Concerns Hyman P. Minsky

The Two Cambridge Controversey - which seemingly was about esoteric matters in capital theory, was really about the validity of the neo-classical synthesis, today's standard economic theory. The outcome of the controversey has been a victory for Cambridge, England, and with that victory the claim that neo-classical theory is a logically consistent and relevant theory for our economy has evaporated. The reason this is so is that neo-classical theory has as one of its fundamental constructs, production functions which contain capital as a variable and this capital in the production function is independent of the functioning of the economy.

But as the only economic meaning that can be given to a quantity of capital is the present value of the future returns that are expected to be imputed to capital, the variable capital in the production function depends upon current views about future gross profits after taxes and the current discount rate. In particular it follows that it is logically inadmissable to take a derivative of output with respect to capital as a functional relation that in any sense or form is used as a determinant of the interest or discount rate. That is the derivation of the "productivity" side of the productivity and thrift view of interest rate determination from production function and the use of relations derived from production functions to determine income distribution are logically inadmissable exercises.

The significance of this collapse of the logical foundations of the neo-classical synthesis for monetary analysis and current economic

policy is that the neo-classical synthesis is the "pure theory" that underlies the theory.of both the monetarists and the so-called Keynesians. The basic faith of those who subscribe to the neo-classical syntehsis has been well-stated by Friedman:

> "...despite the important role of enterprise and of money in our actual economy, and despite the numerous and complex problems they raise, the central characteristics of the market technique of achieving coordiantion is fully displayed in the simple exchange economy that contains neither enterprises nor money." (Milton Friedman: Capitalism and Freedom, University of Chicago Press, 1962, p. 14, my emphasis).

Certainly every monetarist, and in truth every "so-called Keynesian," needs to subscribe to the confession of faith that Friedman so well articulated. Inasmuch as the neo-classical synthesis is an equilibrium and equilibrating theory, the obvious fact that in our economy deviations from full employment at stable prices occur has to be explained by disturbances that impinge upon the economy from outside. Friedman's and all neo-classical economists - have no mechanism that is internal to the functioning of the economy that generates the observed deviations from full employment - what they have is a Devil theory of the generation of business cycles, and the Devil is the government in the Central Bank. The obvious fact that serious business cycles existed in capitalist economies, when the government was tiny and non-interventionist and when Central banks did not exist, has to be ignored or explained away.

It is important to note that in Patinkin's work processes are defined by which a return to full employment is guaranteed but there is no description or analysis of a mehhanism by which deviations from full employment are generated.

The reason I referred to the so-called Keynesians when I mentioned the standard opponents of the monetarists who you keep dredging up to testify before your committees is that it is quite clear that the Hicks/Hansen tradition, which is the basis of their analysis and policy recommendations, really missed the point about the content of the General Theory. It has always amazed me that the Hicks/Hansen tradition has been accepted as a valid interpretation of Keynes in the light of Keynes' vigorous repudiation of such an interpretation in his strongly worded and precise rebuttal to Viner's great review of The General Theory. In truth in the standard economic theory of today, the main messages of Keynes General Theory are conspicious by their absence.

First of all to understand Keynes we must recognize that Keynes was dealing with an explicitly capitalist economy with sophisticated financial institutions. He was shifting the focus from the never-never economics of a Village Fair - which is Friedman's exchange economy - thethe real flesh and blood economy with a Wall Street, trade unions, corporations, etc. The problem Keynes set was to explain the cyclical behavior of such an economy as a systemic and not accidental attribute. In doing this - long before J. Robinson asked her questions about Capital - Keynes developed an investment theory in which what we would now call portfolio speculations dominated, to the point of exclusion, productivity (i.e. production function attributes) in determining investment. Keynes fully realized that in a modern capitalist economy you could have a theory of investment which is not based upon production function notions. In fact, aside from the short

run output-employment relations the technical conditions of production are background but not basically determining relations for income determination. A good way to interpret The General Theory is that is is an investment theory of the business cycles and a financial theory of investment. In turn the investment process was clearly related to Keynes' views about decision making under uncertainty, a problem he had treated at length in his Treatise on Probability. Keynes without uncertainty is like Hamlet without the Prince!

The combination of the victory of Cambridge England in the controversey with Cambridge, Mass and our appreciation that Keynes' message was lost in the academic interpretation means that we really have to go back to the square zero in our economic theory and policy analysis. We have to develop views as to how this inherently unstable economy generates its history. For in truth Keynes was not offering minor modifications of standard theory, he was offering a major revolution in the way in which we look at our economy. In truth we are not working out our prescribed destiny in a regime determined by technological production functions and genetic preference systems; we are living in a social environment which reflects policy choices. In our policy decisions we not only affect how much and at what price.level but we also determine what kind of production processes and output will be produced and for whom output will be produced.

The basic problem of monetary theory was well stated by Keynes in 1931 when he wrote:

> "There is a multitude of real assets in the world which constitutes our capital wealth - buildings, stocks of commodities, goods in the course of manufacture and of transport, and so forth. The

> nominal owners of these assets, however, have not infrequently borrowed money (J.M. Keynes emphasis) in order to become possessed of them. To a corresponding extent the actual owners of wealth have claims, not on real assets, but on money. A considerable part of this 'financing' takes place through the banking system, which interposes its guarantee between its depositors who lend it money, and its borrowing customers to whom it loans money wherewith to finance the purchase of real assets. The interposition of this veil of money between the real asset and the wealth owner is a specially marked characteristic of the modern world" (J.M. Keynes Essays in Persuasion, Volume IX of the Collected Writings of John Maynard Keynes, MacMillan, St. Martin's Press, for the Royal Economic Society, London and Basingstoke, 1972, p. 151).

Money in our capitalist economy is not some generalized ration point, it is not something that is introduced in order to eliminate the necessity for a double coincidence of wants at a Village Fair, it is one among a set of liabilities that are used to finance position in the assets held by banks; and the assets held by banks are typically liabilities that finance position in capital-assets. The roles of money, creation and of the substitution against in the financing of position are the mechanisms by which money and velocity are related to price and income formation. However the fundamental determinants of the price level are the money wage rate forced by the way we chose to run the economy. The mark-ups on money wages reflects the relations between the wage bill in the producion of consumer goods and the wage bills in the production of investment goods and from government transfer payments and capital income, employment, together with the consumption financed by any success in achieving increased proportions of investment, government employment, and transfer payments to consumption output will result in a rise in prices relative to money wages: i.e. it will force an increase in what can best called the

the supuplus.

In order to achieve such increases in non-consumption allocations it is necessary to externally finance: either or both of business and government deficits mest be financed. Such a supply fo financial instruments in our complex financial system draws forth a supply of finance - and profit maximizing bankers push their liabilities (i.e. money) in order to acquire assets. Thus an ex-post relation between money and prices/output might be found by econometricians who do not think but compute, and who regularly stransform, i.e. corrupt their data.

The processes by which an initially robust financial system - such as ruled at the end of World War II is transformed into the current fragile financial system is the fundamental instability of a capitalist economy such instability is both endogenous and inherent in an economy in which financial arrangements are at all like the ones we have. The way in which success transforms an initial preponderance of hedge finance with a modest admixture of speculative finance with an absence of Ponzi finance into a situation in which entire financial industries (such as the R.E.I.T.'s) are based upon Ponzi finance is a fundamental way in which the endogenous destabilizing forces can be observed.

It is no accident that in the aftermath of the Great Depression and the financing of World War II we had some 120 years in which no serious threats of a financial crisis arose. It is no accident that in the past decade we have had three real threats of a financial crises: the crunch of 1966, the Penn Central/Commercial Paper Market affair of 1970 and the continuing threats of massive belly-pps in our ongoing perils not only of New York but of TWA, REIT's, Grant and modest Banks, etc.

The debt-deflations that are part of a Great Depression were the historical technique by which fragile financial systems were transformed into robust financial systems. From the trivialization of Keynes that became popular theory we learned how to avoid not only great depressions but also to constrain mild recessions. However in order to avoid debt deflation there is a need for the Federal Reserve to validate the ever more layered speculative finance, and this implies increases in government spending, investment, and transfer payments, which as was pointed out earlier, are transformed into profit margins. Thus accelerating inflation is the price we pay for avoiding Great Depressions in a regime of fragile finance. I believe it is no accident that inflations really began to accelerate and became the problem it is today in the past decade - when the fragility of the financial system became evident.

Rational policy can only be based upon a recognition that there are inherent flaws in the market mechanisms of a capitalist economy and the function of policy is to contain the repercussions of the flaws. We cannot achieve a "perfect financial society" as long as the freedom to speculate exists - but by appropriate structural legislation we can achieve a better financial society than now exists - one in which the tendencies, so evident today, for instability, inequality, and inefficiency to increase are moderated.

Cpngress through its programatic/investigative function is the great legitimizer of reform. Rather than lay out the program of reform I believe follows for the financial instability view of our economy. I want to take this opportunity to suggest that now is the time for another grand congressional inquiry into the structure and functioning of the American Economy ; an inquiry that looks towards the reform and reconstruction of our economic institution. What we need is another Temporary National

Economic Commission or at least another Congressional study like the great Paul Douglas investigation of 1958/59 into Employment, Growth and Price Levels.