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Profits, Deficits and Instability: A Policy Discussion

Remarks by

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Presented at the Inaugural Conference Of the Levy Institute: Moderator: Tom Asimakopulos, participants Robert Eisner, Charles Kindleberger, Hyman Minsky and Albert Wojnilower.

I. Introduction

We are here today at this magnificent site because some four score years ago Jerome Levy had the insight that the cyclical behavior of a capitalist economy depends upon the course of profits through time, and that this course depends upon the structure of what we would now call aggregate demand. In particular Jerome Levy's advanced the proposition that in a simple small government capitalist economy, with external trade mostly in balance, total profits equals investment. In the argument that follows upon this insight, investment is shown to be the independent variable and profits the dependent variable. This leads to a simple equation:

$$\text{Profits} = \text{Investment.}^1$$

In thinking about economics as he did Jerome Levy anticipated the economics of Keynes and Kalecki.

However investment takes place because profits are expected in the future, and in turn these future profits depend upon future investment. A paradoxical proposition results: Investment takes place now because the main actors in investment decisions, entrepreneurial business men and bankers, expect investment to take place in the future.

The simple skeletal profit equals investment relation can readily be expanded to allow for the structure of our sophisticated economy. Complications in the theory that are introduced in order better to mimic the world in which we live establish that in a complex capitalist economy:

$$\text{Profits} = \text{Investment} + \text{Government Deficit} - \text{The Deficit on International Trade} \\ - \text{Savings out of Wages} + \text{Consumption out of Profits.}^2$$

Each element on the right hand side of this profit identity can be replaced by a behavioral equation. This set up can be used to construct a macroeconomic model that first determines aggregate profits and then determines aggregate demand.

Jerome Levy's insight leads to the proposition that the mass of profits are determined by macroeconomic relations, in particular the structure of demands and the availability of financing. Individual profit seeking businesses compete for shares in this aggregate. One aspect of this competition is that firms strive for efficiency in production, another is that firms strive to carve out markets that can be controlled. Each entrepreneur, aided and abetted by his bankers, aims to contain the exposure of his firm to profit eroding competition. This view, that macroeconomic relations determine aggregate profits and that market power and the technical conditions of production

1. S. Jay and David A. Levy, *Profits and the Future of American Society*, New York, Harper and Row 1983.

Michal Kalecki

Hyman P Minsky, "Finance and Profits" Chapter in H. P. Minsky "Can it Happen Again" M.E. Sharpe & Co. Armonk, N.Y. 1962 and Stabilizing an Unstable Economy, Yale University Press, New Haven, Conn. 1986

2 This expanded profit equation can be considered as the equivalent of the $Y = C + I + G + X - M$ equation that is the base of the econometric forecasting models.

determine the distribution of profits among firms, is fundamentally different from the orthodox view which holds that both the mass and the distribution of profits are determined by competition and the technological conditions of production.

It follows from this view that effective stabilization policy stabilizes both realized profits and expectations of the future flow of profits. In a modern economy profit expectations are stabilized by policy measures that operate upon the inducements to and the financing of investment, the government deficit, the propensities to consume and the foreign trade balance. If structural relations, such as the government's commitment to spend, the tax code and the size of government, are such that the government deficit quickly moves in the opposite direction from investment, then both realized and expected profits will be stabilized. Once rational bankers and business men learn from experience that actual profits do not fall when private investment declines they will modify their behavior to take advantage of the stability of profits.

By focusing on investment and the financing of investment, as well as the financing of positions in capital assets, a profit oriented analysis of capitalist economies leads to an emphasis upon the proximate institutions with which business men interact as they seek financing. The structure of financial institutions and the instruments used in financing activity are important determinants of what happens. The flows of payments from debtors to fulfill financial contracts and the flows of funds from financial institutions to investing units are important in determining the path of the economy.

In our economy at every date liability structures prior commit a portion of gross profits to the validation of debts even as contracts are negotiated which commit future profits to the payment of interest, dividends and the repayment of principle. The flow of such contract fulfillment payments to financial intermediaries, money managers and ultimate owners of financial instruments is a principle source of the funds that are available to acquire newly issued financial instruments. A shortfall of contract

fulfillment payments implies that the market for new contracts to finance investment and positions in both newly produced and inherited capital will be adversely affected.

A comprehensive or systemic shortfall of profits below what had been anticipated or "expected" when financial engagements were undertaken diminishes the flow of new financing for investment. This will tend to lower investment and lower gross profits. As the repercussions from an initial shortfall of cash to validate debts impinge upon financial institutions available financing decreases, which can lead to further subsequent shortfalls in cash available to validate debts. The financing circuit - the flow of funds from gross business profits to the validation of debts to the supply of funds for investment financing - implies that a potential for a debt deflation, such as took place between 1929 and 1933, exists in the normal processes of the economy.³

All economies with sophisticated financial institutions have developed formal or informal institutions that intervene to try to contain or abort debt deflations. We may be in the midst of a slowly developing debt deflation that will test whether the crisis containing mechanisms of our economy, which are largely inherited from the 1930's are apt.

Let us ignore questions as to the genesis of current and recent financial crises and who is to blame. The stock market crashes of October 1987 and 1989, the debacle of the savings and loan associations and the FSLIC, the continuing problem of Latin American debts, and the possible unravelling of the junk bond market show that aborting or containing of potential debt deflations is a serious current policy problem. Over the 1980's a dominant determinant of Federal Reserve System actions has been the need to act as a lender of last resort in response to financial trauma.⁴ We can expect

3 Irving Fisher The Debt Deflation Theory of Great
Depressions, Econometrica 1933
H. P. Minsky, Debt Deflations Quarterly Review
J. Caskey and S. Fazzari

4 This has been documented by R. Giordano

that as financial and economic uncertainty become more evident policy will turn to creating a financial structure that is better able to support tranquil growth.

The perspective on the economy that follows from Jerome Levy's insight emphasizes money flows which tie the financial realities of the economy to the size and type of incomes that are generated in production and distribution. A strong form of orthodox economic theory finds that what happens in financial markets to be of little or no importance in determining what happens in the economy.⁵ In sharp contrast the economic theory that begins with the formulations of Levy, Keynes, and Kalecki makes financial relations and the financing of activity critical determinants of system behavior.⁶

II. Financing

In a modern capitalist economy investment is always an exchange of money now, which is used to pay for the creation of capital assets, for future money that is expected to be forthcoming as the capital assets are employed. Investment therefore depends upon present financing conditions and present views of future profits of the business men and bankers who whose negotiations lead to investment financing.

From the perspective of investing units financing conditions are the terms upon which money now can be obtained for a range of contractual and contingent commitments to pay money in the future. The money raised now is presumably committed to the creation of capital assets. Thus the economy can be characterized by a structure of profit realizations and expectations by firms that operate the economy's private capital assets and who need to fulfill contractual payment commitments. Both

5. The classic statement is the Modigliani-Miller theorem.
F. Modigliani and Miller

6 Another way of phrasing the above is that money is neutral in orthodox theory but it is not neutral in the economic theory that is built on a Levy-Kalecki framework.

the economy's capital asset and financing structure link the past, the present, and the future.

Keynes's comment to the effect that an outstanding characteristic of the world in which we live is "A system of borrowing and lending based upon margins of safety" is evident in financial commitments. The margins of safety that are embodied in contracts as they are negotiated reflect the beliefs of both the borrowers and the lenders as to the assurance of expected cash flows. These expectations reflect views about the nature of the economy as well as the rational man's knowledge that experience may falsify expectations. The rational assumption for an economist to make who attempts to deal seriously with investment is that business men and bankers are wise enough to understand that the theory they hold to be true, which guides the formation of their expectations, may be false.

The liability structure of a business organization is a prior commitment of profit flows. Similarly household debt is a prior commitment of household income, government debt is a prior commitment of tax receipts, and international debts are prior commitments of balance of payments receipts. The complex financial structure of a modern economy rests upon the size and distribution of cash flows that the production of income generates.

III. Uncertainty

Keynes introduced the proposition that financing is based upon margins of safety into the discourse. But no one, not even rational hard nosed analysts out of more mathematically oriented business schools or Ph.D. programs in economics, *knows* the future that is relevant for financial decisions. Financial decisions are made on the basis of a future conjured up by borrowers and lenders as the result of negotiations in which information and disinformation are exchanged. The negotiated result reflects views about the prospects of a particular project in the light of the successes and failures of the economy over the recent and more distant pasts. The attitudes of agents towards risk, what economists call risk aversion, is not a genetic trait but rather reflects perspectives on how the economy works which are derived from both the recent and longer term performance of the economy.

In the current world expectation formation has to combine:

1. the overall success of leading capitalist economies since the end of World War II,
2. the spate of financial trauma over the past twenty years whose extent and effects have been contained, and
3. the knowledge that in the 1930's capitalist economies were failures.

The ruling expectations will differ and therefore the behavior of the economy will differ if business men and bankers determine their behavior by using of a model that maintains that capitalist economies are normally successful rather than by using a model that maintains that what happened between 1929-33 was a normal though rare event which can happen again if appropriate circumstances reign. Investment and financing can be expected to ride right through a financial crisis if the first view is dominant whereas a financial crisis may have serious repercussions if the second view is dominant. A fundamental uncertainty in an economy where financial disruptions occur from time to time is what model of the economy guides the behavior of the agents in the economy and what leads agents to switch from one model to another.

Agent's uncertainty as to the appropriate model to use in forming expectations is especially marked if a substantial number of years have elapsed since the last financial crisis that was associated with a deep depression. Over the intervening years both legislated and administrated actions and evolutionary developments changed the institutions of the economy. As a result the past has become a less than perfect guide to the behavior of markets and institutions, especially in a world where central banks exist and are supposed to intervene to contain financial crises. Central banks are supposed to assure that "It" (a debt deflation) will not occur, but "Are they able to do so?" becomes a question that guides decisions. In particular what is the model of the economy that guides the actions of the present Central Bankers and under what circumstances will this model change.

This fundamental uncertainty means that the margins of safety that units seek to attain will vary. Two types of margins of safety can be distinguished. One is the excess of expected cash flows in over the cash flows committed by the liability structure. The second is the asset structure of portfolios, where money and instruments which are readily marketable at prices that are largely assured provide safety in the form of liquidity. We can expect the desired level of both of these margins to diminish over periods of protracted success, and increase suddenly if events trigger a pessimistic reevaluation of prospects.

If a firm's or its banker's desired margin of safety increases then units are likely to use available cash flows in excess of those needed to fulfill payment commitments to reduce debts. This will tend to decrease investment and if generalized lower profits. Alternatively firms and bankers can try to increase their holdings of monetary or liquid assets. This will lower the market price of shares, ordinary debts and capital assets. As the financing terms for new debts increase to meet the rates available from the depreciated inherited assets, investment and therefor profits will tend to be lower. The reactions to a shortfall of profits in a world characterized by uncertainty as to the

correct model of the economy to use in drawing inferences about how the economy will behave may well make things worse not better.⁷

7. Cite Caskey and Fazzari

IV. What is going on now?

Irving Fisher published "The Debt Deflation Theory of Great Depressions"⁸ in 1933, soon after the Great Contraction that began in 1929 reached its climax. Fisher identified a nine link process of debt deflation, which had as an initial condition "a state of over indebtedness". The over indebtedness, which Fisher never really explained, led to failures to fulfill commitments on inherited debts, contractions in new debt, and declines in what we now call Gross National Product, prices, wages, employment and profits. The reactions by households, businesses and financial institutions, each attempting to do the best they could for themselves in the existing situation only made the situation worse. A debt deflation demonstrates that markets are not always self equilibrating within the time frame relevant to human life.⁹

Over the period 1929-1933 current dollar GNP fell by roughly 50%. Over this period government did not decrease so that government as a % of GNP increased from 3% to 6%. We know that humanitarian rather than economic impulses led the Roosevelt administration to further increase the size of government. The recovery of 1933-36 took place as profits revived under the stimulus of increased government deficits and a revival of investment.

Were it not for the size of the government and lender of last resort interventions we would have experienced a close approximation to a debt deflation and a serious depression several times during the past twenty years. Even with the size of government, the refinancing of the FSLIC by the government, and the support that banks and other financial institutions receive from the FDIC and the Federal Reserve the current situation may get out of control. This is so because of the smaller weight

8. I. Fisher op cit.

9 H. P. Minsky Debt Deflation Processes in Modern Economic Environment.

that the United States now has in the world economy, the way the dollar has been compromised by fiscal deficits and the questionable willingness and ability of the now more important Europe and Japan to act as the sustainers of global profits.

The 1980's began as an euphoric period for the banking and financial community in the United States. The tax and spending policies of the Reagan administration created a fiscal policy posture that was equivalent to a war. The massive increase in the government's debt and the deterioration in the balance of trade are evidence for the war economics reading of the 1980's.

The exception to a war economy reading of the Reagan years is to be found in the labor market: Johnny did not go marching off to war. As a result the prolonged expansion and economic euphoria took place without creating a tight labor market.¹⁰ The weakening of unions during the 1980's by government being unfriendly, protracted unemployment and a product competition from imports meant that the expansion of the 1980's took place with a decrease in the rate of increase of money wages: an euphoric expansion took place even as the rate of inflation decreased. The wage and cartel driven inflation of the 1970's was replaced by a more modest inflation that was driven by profits and interest rates. The rentier was resuscitated in the 1980's.

V. Apt and inept intervention.

The trajectory that an economy follows through time depends upon the interactions between endogenous dynamics, that would determine a not necessarily satisfactory path of the economy through time, and constraints and interventions which make up a structure of regulation, which contains the economy to what are expected to be tolerable or satisfactory outcomes. It follows that over the longer run the satisfactory

10. Charles Kindleberg

performance of a capitalist economy depends upon the aptness of the structure of regulation. Because profit seeking agents learn how a regulatory structure operates and because regulation means that some perceived profit opportunities are not open to exploitation, there are incentives for agents to change their behavior to evade or avoid the constraints.

This implies that over time the consequences of a structure of intervention changes. Interventions that start out being constructive can be transformed into sources of instability and inefficiency. The debacle of the thrifts and the hapless performance of the FSLIC as it tried to cope with the problems of the 1980's demonstrates that a structure of regulation and intervention that initially was successful become perverse. The experience with the thrifts and the FSLIC is not an argument for laissez-faire but rather an argument that intervention cannot be frozen in time but must adapt as institutional and usage evolution takes place: successful capitalism requires both a structure of regulation and a sophisticated awareness of the way profit seeking drives the evolution of structures and behavior.

The FSLIC debacle can serve as a model for the pitfalls that the regulation of financial institutions faces if the regulators are not aware of how the incentive structure is affected by regulation. Initially in what I call the Jimmy Stewart days savings and loan associations were real estate financing institutions which operated within a local community.¹¹ The great contraction played havoc with real estate values and the ability of households to fulfill their mortgage commitments. Even though the typical mortgage was of relatively short duration, many savings and loan Associations found themselves in a liquidity bind and with questionable net worths. Runs and suspensions of payments occurred. The performance of the building and loan associations in the 1929-33 contraction was even worse than that of the commercial banks.

11 The reference is to Its a Wonderful life, a classic feel good film.

A major objective of the New Deal was to create an economy in which home ownership was widespread. To further this objective mortgage and deposit insurance were instigated. Deposit insurance was not a free good. The premium structure imposed costs but more importantly the deposit insurance organization had the right to examine and guide the behavior of insured institutions. Examination and constraints upon behavior were part of the deposit insurance deal. The Savings and Loan Associations were simple institutions with local home mortgages as their primary asset and pass book savings as their main liability: a simple minded management, such as that provided by the Jimmy Stewart character in the aforementioned film, would do.

Deposit insurance was put in place in the aftermath of the failures of building and loan societies to assure depositors that their funds were protected, to overcome depositor aversion created by the experience of 1929-33. With deposit insurance and bank examination there was three levels of protection for deposits:

1. Cash flows of the insured organization due to fund income supplemented by fee incomes,
2. Equity of the deposit institutions, and
3. Deposit insurance.

The deposit insurance fund was protected against claims by the positive cash flows of the insured institutions and their positive net worth. The Home Loan Banks were put in place to provide liquidity, to enable S&L's to acquire funds when they had a cash drain. The Home Loan Banks also provided channels by which funds in excess of what a local community could provide were available in rapidly growing regions. With mortgage insurance, deposit insurance and the provision of liquidity by the Home Loan Banks it was believed that the standard home loan mortgage could be safely transformed into a long term, fixed interest rate, and fully amortized instrument for which the monthly payments for modest homes were in line with what a worker earned.

The flaw in this set up was that the S&L's were funding long term fixed interest rate mortgages with short term funds. The rates on the mortgages in portfolio set an implicit ceiling to the deposit rates and the cost of services that the S&L's could meet. The institutional structure put in place in the 1930's assumed that interest rates would not escalate rapidly, i.e. that accelerating inflation would not be a major nor a lasting problem, and that alternative assets to savings deposits that paid market interest rates would not be available for "small" depositors.

The Volcker era, 1979-1986, saw high and rapidly escalating interest rates and the development of new instruments which offered risk averse investors presumably safe returns. These developments forced the savings banks to meet the market. The result stripped the savings banks of their surplus cash flows and equity. The only protection remaining for depositors was the protection afforded by deposit insurance. Given the evaporation of the protections that positive cash flows and institutional equity provided for the deposit insurance fund, supervision of the thrift institutions should have tightened. Instead an ideology of deregulation ruled the land and the savings institutions were granted the ability to broaden their portfolios by buying corporate debts and by financing land development and construction: they were permitted to move into the high risk part of construction financing.

As many savings and loan associations had a negative net worth and were making losses, it was possible to buy control of a great deal of funds with a small investment. Business plans to grow out of the current losing situation by acquiring high yielding short term construction and land development positions were put forth and accepted by regulatory authorities.

If a banker has a customer whose cash flow is negative and whose net worth is evaporating then the banker's supervision becomes ever more close. Bankers are known to become intrusive in such work out circumstances. They certainly don't give such a zero or negative net worth customer an unlimited line of credit. In the case of the

savings and loan associations even as their cash flows and equity were stripped supervision was relaxed: they were in effect given an unlimited line of credit.

During the 1980's the supervisory oversight of savings institutions became ever more relaxed. The negative net worth organizations took on high interest rate assets and increased their liabilities, presumably guided by a strategy of growing out of the negative net worth situation. One objective was to increase fee incomes and lessen the reliance on fund incomes. Fee incomes are associated with volume. One way to obtain volume is to relax loan standards.

The strategy of growth and asset diversification led to the S&L's booking large profits largely as a result of accrued income. A slowdown in real estate activity meant that the underlying land and development assets were yielding no income and as a result there was no cash flow to pay financing costs. The S&L's solution was to allow debtors to pay interest by adding to the amount owned. The institutions booked such accruals as income and used them to pay interest and other expenses such as officers salaries and perquisites and fees to accountants and consultants to attest to their profitability.

Deposit insurance was never insurance in the sense that there was an actuarially sound assesment of exposure and a fee structure that along with interest income on prepaid fees paid for losses. Deposit insurance was able to pay for the occasional losses of the 1935-1980 period, but as almost all losses were due to fraud or gross incompetence, a bonding operation would have sufficed. Deposit insurance as protection against systemic losses by depositors at banks and thrift institutions was always a pledge of the full faith and credit of the United States.¹² Although Congress had asserted the full faith and credit obligation from the beginning of deposit insurance, Congress evaded

12 Cite Campbell and Minsky:

funding the payoff of deposits in the early part of the 1980's when losses by S&L's overwhelmed the insurance funds reserves.

There is no need to go through the sorry tale of the collapse of savings institutions and their deposit insurance fund: there is blame enough to go around. It was undoubtedly a combination of ignorance and venality: dumb officials and openings for scoundrels. What needs to be recognized is that an inept system of intervention can emerge out of an initially apt system. Intervention is necessary but has to be done wisely, which means that the theory of how the economy functions cannot be the naive neoclassical theory in which unconstrained markets always reach the best result.

Although Congress has provided some funds and a new organization to resolve the problem of the thrifts, the actual funds provided seem certain to fall short of the amount needed to validate all of the deposit liabilities. Further funds will have to be provided. What Congress is doing is validating a commitment made in the 1930's. The question that has to be asked is how good is the full faith and credit of the United States.

Debts are prior commitments of future incomes. The incomes being committed as Congress authorizes the issuance of debts are future tax receipts. But the United States now has a structural deficit in the government accounts which is smaller than the interest payments on the government debt. The government is engaged in a variety of Ponzi finance. If the full faith and credit of the government is to have lasting worth then the government budget has to be in a structural surplus: i.e. the budget will run a surplus whenever the economy is at full employment and there is no special spending such as a war brings forth.

The present situation may be described as the beginning of a debt deflation process during which the monetary and fiscal authorities engage in a series of interventions in an effort to contain or abort the process, even as these authorities are not knowledgeable about the flaw in the economy that make debt deflation processes

normal results. As a result intervention is likely to be ineffectively. Intervention that is not based upon an understanding of how profit flows are generated and the relation of profit flows to the validation of debts may stifle the debt deflation process today only to witness the process starting up in another sector in a more virulent form.

VI> Policy:

The S&L crisis has been put on the back burner by the recent legislation and the understanding that more government funds will be available if needed: the government's full faith and credit is on the line. But the government's full faith and credit is meaningless unless the government's revenue sources are ample. An in principle balanced budget or surplus after the debts needed to meet existing and future commitments are added to the outstanding amount is needed.

Even after allowing for the repercussions from the breakdown in the Soviet structure this is likely to require a rise in taxes need. Raising taxes implies a decline in income and profits, unless the other determinants of profits change so as to increase profits.

The hemorrhaging of profits by way of the trade deficit needs to be stopped. At present the policies of the great asset holding surplus countries, Germany and Japan, can be described as begging their neighbor. They achieve prosperity by impoverishing the United States. The drainage of profits from the United States by our trade deficit is an infusion of profits into the Germany and Japan by way of their trade surplus. This begging is in addition to the claims upon future United States profits that their asset accumulations represent.

There is need for a tariff for revenue purposes. There is no need for the exclusionary tariffs such as Smoot Hawley represented, furthermore Smoot Hawley was a trade restriction by a creditor country that was prosperous. The present situation calls

for a tariff designed to stabilize profits in the face of a need for substantial increases in revenues.

It is likely that a tariff for revenue purposes will not be sufficient to meet the enlarged revenue gap that the refinancing of the Savings and Loans requires. The usual suspects such as a substantial excise tax on gasoline and a value added tax need to be considered.

Tariffs increase the market power of domestic firms and unions. A strong pro competitive "anti-trust" policy needs to accompany the tariff. Labor's demand for good jobs at good pay will be at least partially satisfied by the price differential induced by a tariff if there is no exploitation of the market power that accrues to management and labor by the tariff. A strong and an effective pro competitive market strategy needs to accompany the tariff.

VII. Conclusion.

The popular response to the proposition that a debt deflation is possible or that "It", a Great Depression, Can Happen Again" is "They won't let it happen." The response to that is "Who are the they?" and "What are they to do?" We are now closer to the Fisher initial condition of over indebtedness than ever before in the era of big government capitalism and we are closer to a triggering of a debt deflation with the S&L crisis and other banking system crises than ever before in the era of prior government guarantees of the safety of deposits and the probity of markets. The refinancing of the FSLIC is aimed at aborting a debt deflation, even if the players in the game do not know that is what they are doing. They may succeed in containing the present crisis, but unless the full refinancing takes place and the issue of the adequacy of aggregate profits to finance development is faced all that will be accomplished is to slow down the process: the chaos that it took 42 months to achieve in 1933 may now take say 84 months.