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Financial Crises: Systemic or Idiosyncratic:

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My aim is to broaden the discourse, to put reforms on the agenda which go deeper than those that are now on the agenda.

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I. INTRODUCTION.

The presentations at this conference are by economists from Academies and economists who professionally confront real world problems, either in private finance or in public policy. As economists we accept that the remarks made by Keynes in the closing passage of *The General Theory* are true:

"... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.I am sure the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. ... Soon or late it is ideas, not vested interests, which are dangerous for good or evil."¹

We like this assertion, not only because it makes us important but also because it makes good sense.

The ideas that Keynes refers to are theories. A theory of system behavior is a prior for rational action. A proposed action, whether by individual agents in households or firms, a bank, a government agency or a legislative body is appropriate action only as a theory connects the action

¹ J. M. Keynes, *The General Theory of Employment Interest and Money*, 1936 pp. 383, 384.

to the desired result.² Because some institutions, such as deposit insurance, the savings and loan industry, and a number of the great private banks, that served the economy well during the first two generations after the great depression, seem to have broken down, the need to reform and to reconstitute the financial structure is now on the legislative agenda.

As we try to fix the financial system three questions should be asked of the pushers of a policy proposal:

1. "What is it that is taken to be broke?",
2. "What theory about how our economy works underlies the proposal?"
3. What are the dire consequences of not fixing that which you assert is broke?

In what follows I will take up three points

1. Two views of the results of the economic process
2. Systemic and idiosyncratic sources of financial crises
3. Some ideas about the scope for policy in the present "crisis".

II. TWO VIEWS OF THE RESULTS OF MARKET PROCESSES

2. The essence of the rational expectation revolution in economic theory can be summed up in the proposition that the actions economic agents take reflects their understanding, i.e. theory, of how the economy functions.

There are two fundamentally different views about the results that a market economy achieves. One, as stated by Adam Smith, is

"As every individual, therefore, endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenues of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it ... and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."³

The second, as stated by John Maynard Keynes, is:

"If I may be allowed to appropriate the term speculation for the activity of forecasting the psychology of the market and enterprise for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organization of investment markets improves, the risk of the predominance of speculation does, however, increase. ... Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."⁴

When designing and advocating policies economists and practical men alike have to choose between the Smithian theory that markets always lead to the promotion of the public welfare, and the Keynesian theory that market

³ A. Smith. 1776, An Inquiry into the Nature and Causes of the Wealth of Nations, book 4, chapter 2. italics added

⁴ Keynes, op cit p. 158-9 italics re casino added

processes may lead to the capital development of the economy being ill-done, i.e. to other than the promotion of the public welfare. If the theory that takes the invisible hand conjecture as a guide to the way the economy works is valid, then intervention or regulation can only do mischief. If the theory that takes the capital development of the country may be ill done as a guide to the way the economy works is valid, then regulation and intervention can be beneficial. Furthermore, if the consequences of doing the capital development poorly are serious, then it is politically necessary to create and apply appropriate regulations and interventions.

The Smithian view leads to the proposition that financial crises and the deep depressions which followed arose from particular institutional flaws and not because of any characteristic essential to a market economy.⁵ In the current crisis the institutional flaws which have been identified as being culpable are a system of intervention which allowed some dirty rotten scoundrels to operate, external shocks which dislodged the economy, and not well grounded restrictions on banks. In these views the current crisis reduced to being a result of managements which were

5. Henry Simons, Rules Versus Authorities in Monetary Policy. JPE, 1935. The essential proposition of the first Chicago School was that the flaw in the existing capitalist

allowed to exploit deposit insurance and geographic, lines of business and ownership restrictions on banks.

The Keynesian view leads to the proposition that the essential processes of capitalist economies result in the emergence of conditions conducive to financial instability. Potential instability is a basic from time to time system characteristic, which follows from the pivotal role of investment and financing in capitalist economies.⁶ Law and policy makers need to be aware of the institutional evolution that profit seeking investors and financiers induce and which can lead to both inflationary surges and deflationary disruptions. As such instability may well lead to serious disruptions of investment and profit flows as well as income and employment, an institutional structure which can both contain and sustain profit flows and asset prices is necessary.

In the Keynesian view the crisis of the Savings and Loans and the banking system is the result of a tendency, over protracted periods of good times, for indebtedness and asset prices to outrun the ability of cash flows to validate the debt contracts and asset prices. The current problem is not how to bail out the deposit institutions but how to prevent asset values and profit flows to fall so far that investment collapses and a deep and long depression is

6. This is close to the view of J. Schumpeter The Theory of Economic Development

ushered in. One way to do this is to prevent the dumping of assets by failing financial institutions, for such dumping, by lowering asset values, will play havoc with the mark to market capital of other institutions and with investment. Thus the funds that Congress makes available for paying off deposits in institutions with negative net worth are not only validating deposits but are also preventing the need for these and other institutions to attempt to make position by selling out position. It would be a disaster for asset values if a broad array of intermediaries need to make position by selling out position.

The sophisticated Keynesian view accepts that while there is a need to intervene to keep a market economy performing in a satisfactory manner or to prevent disasters, actual systems of intervention, especially when they are not enlightened by a theory which helps us understand why there is a positive value to intervention, can do substantial harm. Furthermore the Keynesian view recognizes that agents learn and adapt, so that a system of intervention that was apt under one set of circumstances can become inept as the economy evolves.

Theoretical economists and practical persons pay lip service to the invisible hand proposition but, in the modern world, where Central banks are taken for granted, when push comes to shove intervention takes place. Actual behavior is guided by an often implicit theory in which "Markets can do

_____ poorly" is a proposition. One long standing proposition is that markets manage money poorly: the monetarist rule that the Central Bank should see to it that the quantity of money grows at an appropriate constant rate is a reflection of this view. In the Smithian view the savings and loan debacle and the forthcoming crisis in banks and insurance are results of a break down of regulation, including the regulations that guide the behavior of the learned professions of law and accounting,⁷ rather than a consequence of the dynamics of successful capitalism.

The dominant strain in economic theory since the early 1950's - the mathematical general equilibrium theory associated with Arrow and Debreau - is used to support the invisible hand conjecture of Smith as a guide to policy. This is so even though sophisticated contemporary economic thinking recognizes that those proofs in modern general equilibrium theory which validate Smith's conjecture are rather like a lawyer's brief: they conform to the dictum that "These are the conclusions from which I draw my premises". Even so all that the proofs under tight conditions have shown is that a general equilibrium that conforms to the Smith rule exists: the uniqueness and stability of equilibrium are not proven.⁸

7. Martin Mayer "The Greatest Ever Bank Robbery", Charles Scribners Sons, New York 1990

8. B. Ingrao and G Israel, The Invisible Hand, Economic Equilibrium in the History of Science, 1990

Beyond this it is acknowledged that this theory does not allow any room for money.⁹

Keynes "...capital development of a country ... is likely to be ill-done." proposition implies that markets can get the investment decisions wrong as measured by both the amount, too little or too much, or by the distribution among types of investments. As Keynes remarked

"The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be regarded as one of the outstanding triumphs of laissez faire capitalism ..."¹⁰

Keynes pointed out that the prices of the existing stock of assets, both real and financial, as well as the cash payment constraints imposed by the liability structure of the holders of capital assets, may lead to an inappropriate amount or type of investment. If speculation leads to an excessively high investment ratio and debt financing of investment and positions in assets, then excessive demand and inflation are likely to occur. Furthermore as is so evident in the portfolio of the Resolution Trust the investments put into place are often of

9. "The most serious challenge that the existence of money poses to the theorist is this: the best developed model of the economy cannot find room for it." F.H. Hahn, Money and Inflation, Cambridge Mass. MIT Press 1985, p. 1. One peculiarity of this essentially cute volume is that banks and bankers never appear in a volume dedicated to money and inflation.

10. Keynes op. cit pp159: my underlining, my bold.

low value relative to their costs and as a result the liability structures cannot be serviced by the cash flows these investments can generate as capital assets and collapse of the price level of assets is likely to ensue. A sharp break in the price level of assets leads to institutional failures as well as in the aggregate volume of investment. Speculation, the activities identified with Wall Street, make business cycles, including the sporadic deep depression cycles, rather than equilibrium seeking and sustaining behavior the normal result of the economic process.¹¹

In the Keynes view the monetary mechanism is tied to credit and therefor to the financing of activity. The interaction between the financial system and what, for want of a better term, we can call the production system is introduced at the beginning of the argument, when the financing of enterprises and investment programs are "on the table". This is in sharp contrast to the monetarist view where an asymmetry in the perceptions of different classes of agents of some assumed exogenous change in the monetary system is introduced in order to transform an equilibrium seeking system into a cycle generating system.¹² The

11. H.P. Minsky, John Maynard Keynes, New York, Columbia University Press, 1975 interpreted Keynes as putting forth an investment theory of business cycles and a financial theory of investment.

12. Robert E. Lucas Jr. "Expectations and the Neutrality of Money" reprinted in Robert E. Lucas "Studies in Business Cycle Theory" MIT Press 1981.

centrality of money, credit and the pricing of capital assets in the Keynes theory differentiates Keynesian from Smithian theory.

History shows that every deep and long depression in the United States has been associated with a financial crisis, although, especially in recent history, we have had financial crises that have not led to a deep and long depression.¹³ The potential loss to society from a financial crisis will be great if it leads into a deep and long depression. If all that follows from a financial crisis is a redistribution of wealth or a shift of production from investment to consumption goods within a full employment economy, then some concerns about equity and the impact upon the losers in this process may arise. But this would not lead to the same willingness and necessity to intervene and take possible efficiency losses as that which follows once policy is motivated by the possibility that history, which associates serious depressions with financial crises, is a good guide to the consequences of a financial crises in our time. Intervention is ordained if it is believed that a free market resolution of a financial crisis requires doing time in a deep depression.

13. The deep depression cycles in M. Friedman and A. Schwartz, A Monetary History of the United States, 1867-1960, Princeton, National Bureau of Economic Research, 1963 are all associated with episodes of financial instability if not financial crises. See also M. Friedman and A. Schwartz, "Money and Business Cycles," Review of Economics and Statistics Supplement, February, 1963.

III. SYSTEMIC CONDITIONS

A capitalist economy can be described by a set of interrelated balance sheets and income statements. The liabilities of the balance sheet are commitments to make payments either on demand, when a contingency occurs or at specified dates. Assets on a balance sheet are either financial or real and they yield receipts either as the contract is fulfilled, as some underlying productive process generates incomes, or as they are sold or pledged. This balance sheet - income statement way of looking at an economy results in a need to focus on how the prices on the balance sheet and the cash flows that are generated and committed, all measured in a common denominator, the money of the economy, are determined. Capital assets generate cash as compensation for their participation in the production process, financial assets generate cash as the maker is able to fulfill commitments. In addition capital assets, as well as financial assets, can yield cash by being sold or pledged. For pledging or selling to be an option either a broker or a dealer market in assets needs to exist.¹⁴

14. See H. P. Minsky Financial Crisis, Financial Systems and the Performance of the Economy, in Private Capital Markets, Commission of Money and Credit Research Study, Prentice Hall, 1964, Englewood Cliffs New Jersey pp173-380

A fundamental property of all capitalist economies is the existence of a system of borrowing and lending based upon various margins of safety. The excess of anticipated cash flows from asset ownership or participation in income production over the cash flows committed by the liability structure is one class of margins of safety. The excess of the market or the pledge value of assets over the value of liabilities which can require the payment of some principle amount is another class of margins of safety.

A debt instrument or a lease provides for payments to be made on account of both interest and principal. An equity liability has only a contingent commitment to make payments, dividends need to be paid only if earned and declared, and there is no contractual need to repay principal. For any given cash flow, from operations or from the fulfillment of owned contracts, the greater the share of equity financing in a balance sheet the greater the margin of safety that protects the owners of the non-equity liabilities.

In addition to the basic household and firm structure of the economy, there are a variety of firms that both own and issue financial assets. For such financial intermediaries the cash flow to is the result of the fulfillment of terms on contracts, the "placing" of new liabilities, or the sale or pledging of assets. These organizations have a variety of liabilities, each type

having its distinctive expected cash flow out. Among these financial organizations are those which have assets that are longer in duration than their liabilities: these organizations always need to refinance their positions. Such organizations depend upon the normal functioning of various markets, including dependable fall-back markets in case the usual refinancing channels break down or become "too" expensive. The Central bank is the ultimate fall-back refinancing market.

The normal operation of the economy results in the assets owned or operated by a firm yielding a cash flow to the firm. If for some reason an organization needs more cash than the normal cash flow generated by its assets would permit, then it needs to be able to force a cash flow in its favor either by borrowing or by selling assets. But the ability of an organization to force a cash flow in its favor by borrowing or selling assets requires that there be a market in which lending or buying of such assets takes place.

The ability of financial organizations to meet their commitments to make payments often requires the ability to refinance or to sell out positions. But the terms for refinancing or selling out positions may be such that the transaction doesn't yield enough to fulfill payment commitments. This would occur if there are many units in a situation where refinancing or selling out is necessary: the

refinancing organization may have a limited capacity to absorb assets. As a result the market price of the assets can become too low to yield enough funds to meet payment commitments. Central Bank interventions protect at least some set of financial institutions from this contingency.

In prior work I have distinguished between hedge, speculative and Ponzi financial postures. Hedge financing has the normal cash flow large enough to meet both principal and interest that are due on debts, speculative financing has the income of the debtor large enough to meet the interest but not the principal payments and Ponzi finance takes place when not enough is earned to meet the interest due on debts. Speculative finance involves rolling over debts and Ponzi finance involves the capitalization of interest.¹⁵

A fundamental conjecture of a model of the economy that supports the Keynes view is that when hedge financing is the dominant posture the interest rate structure offers inducements to increase indebtedness and increase the proportion of short term financing that requires the rolling over of outstanding debts. Once there is a large volume of short term debts outstanding, which finance longer term

15. H.P. Minsky, "Finance and Profits, the Changing Nature of Business Cycles", The Business Cycle and Public Policy, 1929-1980, Joint Economic Committee, Congress of the United States, United States Government Printing Office, Washington D.C. 1980. Reprinted in Hyman P. Minsky, Can "It" Happen Again?, M.E. Sharpe & Co, Armonk N.Y. 1982.

positions, and institutions exist where such short term debts are regularly rolled over, then a rise in interest rates, a shortfall of earnings or an optimism about future cash flows can lead to the emergence of Ponzi financing relations. It should also be pointed out that there is a respectable type of Ponzi financing, for the normal financing of long gestation investment projects, even where hedge financing dominates, involves the folding of interest on early on costs into the indebtedness on the project.

In all except the financing of long gestation investment projects Ponzi financing involves the erosion of the margins of safety. The payment commitments on debts are increasing as interest is capitalized, even as the ability to acquire profits is not enhanced by investment. Ponzi finance, when it is not construction financing, implies a decrease in equity, for debts increase without any increase in assets.

As a result of the erosion of equity and the decrease in the ratio of cash flow in to payment commitments, Ponzi finance also leads to a deterioration in a unit's credit rating so that a unit's interest rates rise relative to the rates available to the best credits. As a result payment commitments on debt rise faster than debts. The internal relations in a Ponzi situation tend to make the conditions

that led to Ponzi financing in the first place worse, not better.¹⁶

There therefor are systemic conditions that need to be satisfied for a financial crisis to occur: the financial structure needs to be heavily indebted, involving a large element of either Ponzi finance or speculative finance which can become Ponzi. We can characterize a financial structure which is predominantly hedge financing as robust and a financial structure that is heavily speculative and Ponzi as fragile. The fundamental assertion of the financial instability hypothesis is that the financial structure evolves from being robust to being fragile over a period in which the economy does well.¹⁷

The systemic element underlying financial crises is the evolution of the financial structure from being robust to being fragile, from being mainly characterized by hedge finance to having the weight of speculative and Ponzi finance increase. This structural change occurs because the market sets the prices of capital assets in the context of a

16. Some leveraged buy outs include "payment in kind" provisions for some of the indebtedness. Payment in kind financing is Ponzi financing.

17. In a number of papers Mauro Galligatti and Dominico Dela Gatti have shown that once the IS-LM structure is recast in terms of the price of assets and the profit cash flow. configurations in which the economy is stable and others in which the system is unstable can be identified. Further, under reasonable assumptions, the system migrates from financial relations which imply system stability to others which imply system instability. See

specific institutional structure and a set of judgements as to the likelihood of alternative contingent environments. Successful operation of the economy, defined as an interval in which no serious financial crisis and no serious depression occur, is taken to imply that the current institutional structure is less crisis and depression prone than the structure of earlier times. The view develops that those environments that are conducive to crises and debt deflations are not likely to emerge.

The way markets price capital and financial assets often reflects an heroic assumption that the unknowable can be known: that propositions about fundamentally uncertain situations can be derived by assuming that what happens i.e. the data generated by the economy, can be viewed as if it is a sample that has been drawn from a well defined probability distribution. Investment strategies for those who control assets often are derived by treating uncertain situations as if they were amenable to the analysis used to understand well defined probability distributions. But once the randomness associated with uncertainty becomes manifest, the values sustained by this financial strategy become inappropriate. The necessity to adjust portfolios in a world which does not conform to expectations is likely to lead to the collapse of asset values.

IV. IDIOSYNCRATIC ELEMENTS IN THE CURRENT SITUATION.

The extent to which indebtedness can rise before a crisis occurs has changed through time. The fragility of the system is not solely determined by the payment commitments on debts relative to cash receipts. Each period of increased indebtedness has unique elements. The transformation of a downturn from a recession to a depression depends not only upon the overall indebtedness of the economy but also upon the details of the institutional structure and the pattern and efficacy of interventions which have the effect of assuring refinancing and sustaining cash flows.

Innovation, the key to capitalist development, is not just a product and process phenomena: Financial institutions and usages are also subject to innovation. New financial institutions and practices are created, and spread. They have an impact upon asset and liability structures and therefor upon the overall stability of the economy. Each period of rapid financial change and of financial fragility has unique and often interesting characteristics.¹⁸

It is tempting to allow the colorful personalities who crop up in financial affairs to dominate the story of the evolution of the financial system and emergence of financial

18. Joseph Schumpeter.

stresses and crises. One would need more courage than I possess to try to do for our present situation what J.K. Galbraith did for the 1920's and 30's in his classic The Great Crash¹⁹. Today's financial journalists are doing a good job introducing us to today's players, many of whom seem fit to be added to the rogue's gallery of characters who trod the boards in our colorful financial history.²⁰

I want to go beyond the individuals who form the cast of characters of the current crisis. I want to emphasize a few historical and institutional features that are a part of the special causes of the current crisis and which have to be taken into account if the response to the current crisis is to be anything but superficial. Each idiosyncratic element I will discuss is a legacy of past policy decisions.

These policy interventions were guided by a theory: the question of what theory guided policy is relevant. The problems we face now may well be the result of a misspecification by the theories that guided past policies of the processes that determine what happens in our type of economy.

Three special characteristics that make the present situation different from earlier post war episodes of

19. J.K. Galbraith,

20. Martin Mayer,
liars poker,
Barbarians at the Gate,
Greed and Glory

financial tautness will be examined. These are the crisis in the structure of banking and finance, the residue from policies of the 1980's and the maturing of money manager capitalism

IV A The crisis in the structure of banking and finance

The crisis in finance in 1991 is, at least in part, a delayed response to the experiment in practical monetarism that took place in 1979-1982.

Monetarist theory holds that inflation is always the result of too much money chasing too few goods, or some equally simplistic idea. Monetarism instructs us that to control inflation the growth of the money supply, which is defined as currency plus deposits subject to check (M1) or as currency plus total quickly available bank deposits (M2), needs to be controlled. This is achieved by setting the growth rate of bank reserves and currency, what the monetarists call HPM, at a rate corresponding to the desired rate of growth of nominal income. Monetarism instructs the Federal Reserve to give up any pretense of controlling the interest rate: whatever the market sets is to be accepted.

The effect of the monetarist prescription for fighting inflation was to constrain the supply of credit through those bank channels which result in liabilities that are counted as part of the money supply. This constraint upon asset acquisition by banks increased the cost of credit to

borrowers and thus increased the price that purveyors of alternative sources of credit could charge. Profit opportunities in supplying credit through non bank institutions and through markets improved.²¹ This induced the development of new liabilities by banks and other financial institutions, as well as of new market based financing techniques.

Both banks, which have complex portfolios, and savings and loan associations, with focused portfolios, are in the business of lending for a longer term than the term of their liabilities. Banks and Savings and Loans (as well as insurance companies) have to meet the market in order to finance their position. When the Federal Reserve constrains the growth of bank reserves the quick effect is that the cost of liabilities to banks and Savings and Loans rise relative to the income their assets earn. As banks and savings and loans are highly leveraged, a small decline in the return on total assets translates into a large decline even unto recognized losses in the return on equity. Such losses and threats of losses will impair the equity of banks and thrifts and lead them to reach for yield. Such reaching for yield means that they will accept greater portfolio risk.

21. H.P. Minsky Central Banking and Money Market Changes, QJE 1957 (Reprinted in Can It Happen Again)

Market developments which imply that equity is impaired and that banks will reach for yield should alert regulators to tighten their supervision. Bank examination and deposit insurance were easy to do during the first forty-five or so years after deposit insurance was institutionalized during the Great Depression. In fact deposit insurance was largely redundant as long as insurance institutions generated positive cash flows after their cost of deposits and operating costs and the mark to market valuation of their assets was greater than their deposit liabilities.

The interest rate pattern of the period of practical monetarism stripped the deposit insurance funds of the protection provided by the positive cash flows and net worth of the insured institutions. This increases the exposure of the insurance funds which called for tighter supervision. However the Reagan administration was committed to looser regulation and the regulatory bodies followed the elections.

The growth of the alternatives to bank financing that now exist and erode the profitability of banking did not occur because of the working of abstract market forces. The policy that aimed to constrain inflation by reducing the growth of the money supply implied that the competitive position of banks would be weakened. The growth of alternatives to banks and of off balance sheet liabilities of banks were outgrowths of the policy of constraining banks.

One standard critique of regulation is that the regulator is soon captured by the regulated. In the case of the relation between Central banking and banks this has not happened. The attempt to control inflation by controlling bank liabilities provided opportunities for non-bank and market oriented financial institutions and usages to grow and prosper at the expense of banks.

IVB The residue from policies of the 1980's

In mid year 1982 two financial shocks occurred well nigh simultaneously: the collapse of the Mexican Peso and the crash of the Penn Square bank in Oklahoma City. The Mexican collapse was not just a collapse of the peso, it also was a wholesale collapse of Mexican banks, many of whom had financed part of their position in foreign markets and from foreign banks and in foreign currencies. The collapse was the result of private indebtedness of enterprises in the booming north of Mexico and some portfolio diversification by Mexicans, who took advantage of the support to the peso that came from oil revenues and international borrowing. International pressure and domestic political considerations forced the Mexican government to nationalize the debts of the banks: de facto insurance of both domestic and foreign deposits occurred.

The Penn Square Bank crisis centered around the origination of loans for the development of oil and gas

properties by one bank and the take out financing of these loans by other banks. Such a financial usage is necessary if a system of decentralized local and quasi independent banks is to be a dominant characteristic of the financial structure. The Penn Square's placements in a wide variety of banks that wanted a piece of the action in exploring for oil and gas collapsed in mid 1982, and helped bring down a wide variety of banks over the next several years, including Continental Bank in Chicago.

The Federal Reserve's response to the twin collapses was to abandon practical monetarism. Meanwhile the Reagan administration had entered upon the great experiment of lowering taxes, not as a response to a recession but as a means of disciplining government spending, and raising defense spending: the rationalization for this policy was that this combination would unleash economic growth. This radical expansionary fiscal posture was adopted just as the economy received a sharp downside thrust from the bank problems and the Latin America financial crisis. Inadvertently a correct Keynesian macroeconomic posture was struck.

The fiscal posture offset the recessionary thrust from the financial problems: deficits make profits available to business. However instead of stimulating American business, the deficits sparked a burst of imports of a vast array of consumer products. A huge international trade deficit

emerged which transferred profits induced by the fiscal deficit in the United States to those countries that had a surplus in their trade account with the United States.²² In the competition among firms for profits American firms lost to Japanese and other firms in the 1980's.

As a result of the siphoning off to other economies of profits induced by deficit spending, the government deficits of the 1980's did not lead to a commensurate rise in domestic profits and improvement in domestic balance sheets. It therefor did not trigger a sufficient rise in domestic investment, domestic profits and the consumption of domestically produced consumer goods so that income became sufficiently high so that the deficit was sharply reduced or eliminated. The uneven prosperity of the 1980's rested upon a fiscal deficit. The economy never took off so that high income and employment levels were generated without the crutch supplied by massive government deficits.

In prior post war recessions the fall in private investment was first offset by increasing government deficits, which enable businesses and households to fulfill their financial commitments and clean up their balance sheets. After a short interval of dependence of profits on government deficits, investment and employment in the

22. This view of profits reflects what I now call the KLM or Dutch airline theory of profits. See Mical Kalecki, S Jay and David Levy, Profits and the Future of American Society, Harper and Row, New York, 1983 and Hyman P. Minsky.

private economy increased, which tended to eliminate the deficit. In the Reagan era, and to date in the Bush Presidency, the buoyancy of the American Economy has not been sufficiently great so that the need for deficits was eliminated.

In our era federal government spending is in excess of 25% of gross national product. Such big government may well make it impossible to have a depression of the length and depth of the 1929-33 experience. This is so because profits cannot fall to the same extent as in a small government environment. In the light of the now larger size of the government it is necessary to redefine a depression: A depression in a big government capitalist economy is an extended period in which government deficits maintain profit flows, even though income and employment do fall to the extent they did in eras of small government capitalism.

The Reagan era saw a vast increase in the outstanding government debt as well as a fundamental shift in the international indebtedness position of the United States. As a result the United States enters the 1990's with its fiscal independence greatly reduced. Monetary and fiscal interventions to sustain United States profit flows in a recession or in the aftermath of a financial trauma may not be effective unless the trading partners adjust their international posture.

IVC The maturing of money manager capitalism

The most important idiosyncratic characteristic of today's American economy is that the proximate owner of a very large proportion of the liabilities of business - especially of the largest businesses - is some institution that manages money on behalf of an array of claimants. The main money managing institutions are pension funds, mutual funds, and trust departments of banks: the annuity business of insurance companies is a money managing business. To understand the impact of the change in which the proximate owner of the liabilities of corporations are these managed money we have to look at the interrelations among balance sheet that show the structure of financing and of payment commitments of a modern economy.

The capital assets of a modern capitalist economy are mainly but not exclusively owned by corporations. The assets on the balance sheet of corporations are long lived capital assets, inventories and financial instruments and the liabilities are various types of debts and equities. The assets organized into operating units are expected to generate some gross revenues. After deducting current operating costs the gross revenues becomes the gross capital income of the operation. The expectation is that the capital assets as organized into operating units will generate a time series of gross capital incomes.

The equity and debt liabilities of corporations are assets in other balance sheets. Equities and debts are commitments by the emitter of the liabilities to make payments over time to the holders of the assets. In a simple and rude representation of a capitalist economy the liabilities of the capital holding and operating organizations would be assets of households. The financial structure is a way of distributing the gross capital incomes of operating organizations to the households who own the equities and the debts.

Financial intermediation takes place when specialist organizations are interposed between the firms that operate capital assets and the households that are the ultimate owners of the wealth of the economy. As a result of these specialist organizations a mix of financial instruments are developed which serve special purposes. In our economy money, the asset which is always available to meet obligations and whose value in terms of the ability to validate debts is never hardly ever in doubt is just one of the special purpose financial instruments. Over time a labyrinth of financing connections has arisen and the intermediate institutional balance sheets between the capital assets of the economy and the households that are the ultimate owners of the private wealth of the economy has increased.²³

23 Raymond Goldsmith summarized the complexity of financial structures in the financial layering ratios.

In addition to the liabilities of firms which pledge and distribute the gross capital income of our economy there are liabilities of households which are pledges of future household incomes and liabilities of government units which are pledges of future tax revenues.²⁴

In an early and rude stage of capitalism the main financing that took place outside of the own resources of a private, non corporate owner were of goods in transit i.e. commerce was financed through a system of borrowing. This is why the banks that financed such trade were called commercial banks.

As the capital intensity of production increased the need to finance durable assets such as railroads and utilities as well as capital intensive manufacturing and retailing led to the emergence of the corporate form of organizing business and of financiers who arranged for the placement of debts and equities which gathered the finance needed for such enterprises. In this structure the dichotomy between ownership and management was virtually non existent. Corporations were dominated either by a principal often founding owner or by a financier who had arranged for the financing and retained a large interest in the organization.

²⁴ The structure opens up to international financial relations: international debts are pledges of future international trade surpluses.

The combination of the great depression with its attendant reorganization of firms and the second world war, which led to a large increase in household wealth and firms reducing debts and retaining earnings, meant that ownership became widely dispersed and corporate reliance on financiers was greatly diminished. A period in which managers were largely independent of stockholders control emerged.

Over the post war period of successful capitalism in the United States the ownership of property has been more widely distributed than henceforth, but this ownership has taken the form of positions in various mutual funds and beneficial interest in pension funds. These funds need to be managed. The managers of these funds presumably operate in the interest of the owners or the beneficial interests, but they also have interests of their own.

Thus we can distinguish four stages of interrelations between finance and firms in capitalist economies. We can label these as commercial, finance, managerial and money manager capitalism. Each of these types of capitalist structures obeyed quite distinct rules of development through time.

Money manager capitalism has a number of distinct features. The pension and mutual funds have monies for placement on a regular basis. They have outgrown the orthodox high quality stocks and bond portfolios of fiduciaries. They became a market for specialized

instruments such as securitized mortgages, credit card receivables and lower quality, i.e. junk, bonds.

They also play a key role in the emergence of leveraged buy outs. A little known aspect of the leveraged buy out game is the leveraged buy out funds that each of the main players in the game controls. The source of the money in these pools available for equity position in buy outs is largely though not completely the various managed money pools. The emergence of money manager capitalism means that the financing of the capital development

V. Policy proposals

Aside from trivial features and the obvious need to refinance the bank deposit insurance function the administrations proposals are virtually dead on arrival at the Congress.

The Administrations recommendations address the emerging crisis in the banking system as well as the Federal financing of the validation of the deposit liabilities of Savings and Loan associations as problems that are due to specific institutional weaknesses in the banking system rather than any fundamental or deep seated flaw in market economies. In terms of the distinction between Smithian and Keynesian perspectives on the way the economy functions, the Administration's proposals are Smithian for they impute the

problems to a minor flaw in the institutional structure rather than to basic characteristics of the economy.

The proposed reforms include the rather trivial matter of how the supervision of banks is to be divided between the Federal Reserve, the Treasury and a Deposit Insurer. Being a Treasury document the recommendations quite predictably are that the power of the Treasury should be augmented and that the Federal Reserve should specialize in something called monetary policy. The hypothesis is that monetary policy can be separated from any concern about the assets acquired by banks and other financial institutions. The recommendation about governance reflects a belief that banking and finance have nothing to do with the capital development of the economy. They do not address the question of whether the financial system that will emerge after their reforms are in place will lead to our doing the capital development of our economy well.

Within the framework of the Keynesian view the main policy objective is to put a financial structure in place which is conducive to doing the capital development well. This is the criterion by which all policy proposals are to be judged.

A quick and dirty list of some policies that may well be needed if we are to emerge from the present crisis with a financial structure that will do the capital development of the economy well.

1. Development of protection for early outstanding bonds when a major refinancing takes place. The junk bond phenomena in part was a transfer of value from existing debts to the new debts or the initial equity owners. The development of a right to put bonds whenever a serious change in the financial structure of the debtor takes place in a refinancing. The doctrine of conveyance has to be made to conform to current practices.

2. Need to question the pension fund system. Should policy induce a shift to defined contribution schemes? Should the power of pension funds be attenuated by having open ended IRA's (No limit to contributions, withdrawals without penalty but all withdrawals taxed, interest and dividend accruals not taxed except as they are spent.) Opening up the IRA's may well require a thorough overhaul of the income tax. Perhaps the income tax should be transformed into a spending tax.

Because it is desirable that there not be too many impoverished older people allowing for individuals to manage their own pension funds may well require that the Social Security System be opened so that the larger incomes will contribute and larger benefits will be available.

3. The government is no different than any other organization in that it needs revenues to validate its debts. This means that the government should have a normal conditions balanced budget, allowing for deficits in

recessions and depressions and major wars. Inasmuch as a government that spends some 16% to 20% of GNP is more conducive to the normal functioning of a market economy than a government that spends some 3% to 9% of GNP, the tax system must be such that it yields 16 to 20 % of GNP when a close approximation to full employment is achieved.

4. Furthermore the government budget should be designed to have an automatic macroeconomic anti inflationary effect. Indexing as a mechanical device in social security and government pensions should be abolished, so that inflation leads to a substantial budget surplus.

5. Government spending should increasingly be directed towards the creation of resources and the creation of opportunities that enterprise can exploit. The main role of government spending is macroeconomic, to promote conditions that sustain profit flows. The microeconomic impact of government spending should aim to create conditions conducive to resource creation and to enterprise.

6. In the presumed imminent refunding of banks and Savings and Loan Associations the government has been recapitalizing failed banks and S&L's without taking an equity position in the banks. The Hoover Roosevelt Jesse Jones Reconstruction Finance Corporation was a device for equity infusions into organizations that were in principle viable but had been caught by non performing assets which were not performing not because the underlying project had

been ill conceived but because the aggregate economy was performing poorly.

7. One weakness of the banking system centers around the American Scheme of paying for the payments system by the differential between the return on assets and the interest paid on deposits. In general the administration of the checking system costs some 3.5% of the amount of deposits subject to check. If the checking system were an independent profit center for banks then the banks would be in a better position to compete with the money funds.

8. Narrow banks, 100% money and other devices for loosing sight of the main object: The capital development of the economy. The key to banking is the lending or the financing problem: what do the assets of banks represent and is the capital development of the economy better served if the initial interface between the operators of the capital stock and therefor the proximate investors is decentralized into local institutions that can be a department store for financing. This implies that Glass Stiegle must go.

The impact of The innovations in the financial structure on the likelihood of a deep depression

Innovation in payment techniques and in financing forms has been a marked characteristic of capitalist history.

The impact of the Institutional Structure on the Likelihood of a Financial Crisis

The Relation between a financial crisis and a deep depression/on

Free fall of asset prices, need to prevent.

When we go to the theater we enter into a conspiracy to suspend disbelief. The financial developments of the 1980's can be viewed as theater: promoters suspended disbelief with respect to where the cash to validate their projects would come from, even as the agents that financed such projects placed their critical faculties on hold.

In a series of articles in the 1970's Benjamin Friedman observed that total indebtedness was a relatively constant ratio to income, that the composition of debts varied between private and government debt. This observation was brutally contradicted during the 1980's, when both private and government debts increased. One idiosyncratic aspect of the current financial crisis is the result of the violation of the Friedman observation in the past decade

An argument that was developed in the discussion of the Reagan era as a depression era was that fiscal policy must be conservative in that the total government taxing program needs to raise sufficient revenues so that in good times the budget will be either in balance or in surplus.