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The Roosevelt Revolution. “The Ideas Underlying”

Hyman P. Minsky Ph.D.

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Keynes' <u>General Theory</u> --which first revolutionized economists' perspectives and was then absorbed into and emasculated by the neoclassical synthesis--was published in 1936. Even though it was immediately siezed upon by the profession for reviews and critiques--it was not immediately

[illegible] whilst living in an economic structure that reflects either pre-Keynesian views as to how the economy functions or views that were developed while economists dithered as the economy was undergoing the succession of tremors that marked the Great Depression. In particular the pre-Keynesian views that what went wrong reflected "fraud", "speculation" and the incoherence bred of market competition are embodied in the legislated structure. Active monetary and fiscal measures to control aggregate demand have been more or less consciously used since the middle 1940's in an economy whose structural characteristics were largely determined in an era where even the concept of aggregate demand was unknown. It is quite likely that the economic environment largely determined in the absence of the Keynesian insights as to how finance, speculation, and money wages interact to generate aggregate demand, the wage bill, profits, and prices will not be the apt environment for measures aimed at controlling aggregate demand.

From the point of view of the classical economics--and, also incidentally, from the perspective of the neoclassical synthesis--the Great Depression was and remains an anamoly; an event which is inconsistent with the main tenets of the theory. The Great Depression was an event that economists of that day had to explain, and it was a tragedy with which political leaders had to cope. History and experience, as well as the trauma of the stock market crash and the successive waves of bank failures, indicated to

translated into an effective guide to policy. Overt acceptance of what became known as Keynesian economics is a post World War II development. The institutional reform thrust of the response to the Great Depression and the subsequent stagnation was pre-Keynesian, but not classical. Since World War II we have, so to speak, been engaging in what are called Keynesian policy operations whilst living in an economic structure that reflects either pre-Keynesian views as to how the economy functions or views that were developed while economists dithered as the economy was undergoing the succession of tremors that marked the Great Depression. In particular the pre-Keynesian views that what went wrong reflected "fraud", "speculation" and the incoherence bred of market competition are embodied in the legislated structure. Active monetary and fiscal measures to control aggregate demand have been more or less consciously used since the middle 1940's in an economy whose structural characteristics were largely determined in an era where even the concept of aggregate demand was unknown. It is quite likely that the economic environment largely determined in the absence of the Keynesian insights as to how finance, speculation, and money wages interact to generate aggregate demand, the wage bill, profits, and prices will not be the apt environment for measures aimed at controlling aggregate demand.

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both politicians and those economists whose vision was not thoroughly narrowed by the blindness of the classical theory, that what had gone wrong centered in the financial system of capitalism and how the financial system interacted with the real production and consumption aspects of the economy.

Without any really persuasive theoretical support for their views, perceptive economists, such Henry L. Simons of the University of Chicago argued that pervasive reforms and continuing constraint upon the evolution of the monetary and financial system were needed in order to assure recovery from the Great Depression and that it could not happen again. Furthermore Simons and others held that what would now be called expansive fiscal policy was needed to speed and assure recovery. Doctrines, to the effect that the government budget could best be "balanced over the cycle" rather than "balanced" each year, and that large-scale deficit financing and even substantial transfer payment schemes were needed, were very much in the air as the world wallowed in the Great Depression. What was missing was a theoretical formulation which explained why these devices would be effective.[1]

In 1933, as Roosevelt took office, one obvious characteristic of what had taken place in the economy since 1929 was that the price level and money wages were now sharply lower. This was an era in which excess supply in commodity or labor markets led to price and wage declines. Certainly in the United States for all but a few sectors price level and wage level flexibility existed: trade unions were mainly weak and ineffective. The consumers price index fell from 51.3 in 1927 to 38.8 in 1933 (1967=100); the wholesale price

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[1]Perhaps the best statement prior to the second New Deal of a program for a working capitalism is "A Positive Program for Laissez Faire" in H.C.Simons Economic Policy For a Free Society Chicago, University of Chicago Press 1948. "A Positive Program For Laissez Faire" was first published as "Public Policy Pamphlet" No 15, ed. Harry D. Gidonse (Chicago, University of Chicago Press, 1934). Thus Simon's proposals were contemporary with the first and preceeded the second New Deal.

index fell from 61.9 to 42.8 (1947-49=100) over this four year period. Average gross hourly earnings in manufacturing fell from .566 in 1933 to .442 in 1933. This is the consumer prices fall by 24.4%, wholesale prices fell by 30.9% and hourly earnings in manufacturing by 21.9%.

Incidently in 1929 total deposits and currency excluding U.S. government deposits were \$54.6 billions and demand deposits and currency were \$26.4 billions. In 1933 total deposits and currency totaled \$41.5 billions and demand deposits and currency were \$19.8 billions. The decline in total deposits and currency (the M_2 of monetarists) was 23.6% and the decline in demand deposits and currency was 25.0%. The decline in the money supply by either measure was of the same order of magnitude as the decline in consumer prices and significantly smaller than the decline in wholesale prices. Over the same time gross national product in current prices fell from 104.4 in 1929 to 56.0 in 1933-a decline in prices but it could not explain the decline in national income.

If we look at the popular quantity theory of money equation MV=PO and transfer this in logarithms and take the derivation we have that

$$\frac{M'}{M} + \frac{V'}{V} = \frac{P'}{P} + \frac{O'}{O}.$$

We know that $\frac{P'}{P} + \frac{O'}{O} = -46.4$ and $\frac{P'}{P} = -24.4$ so that $\frac{O'}{O} = -22.0$. We also know that $\frac{M'}{M}$ = approximately -25% so that $\frac{V'}{V}$ must decline by 21.4%. In terms of the simple minded monetarist explanations of phenomena the decline in velocity of 21.4%, or alternatively the desire to hold larger price deflated cash balance, has to be explained. Even with the decline in the money stock between 1929 and 1933 the evidence indicates that by prior portfolio standards there was an excess of money sloshing around in portfolios.

Price and wage level flexibility of the kind called for by the real balance effect (which as we have seen closes the neo-classical system to assure that preferences and production functions determines the fundamental properties of a full employment equilibrium) ruled in the era 1929-33. There were of course differences in the movement of various prices. Railway and utilities rates, which were regulated and which reflected significant market power, tended not to fall - and the wages of Federal Government employees were virtually frozen until after Mr. Roosevelt became President. In any period of rapid price level movements not all wages and prices move at the same rate; periods of inflation and deflation are associated with more rapid changes in relative prices than periods of price stability. Any effort to eliminate these price distortions by indexing what would be the "laggard" sectors tended to make the situation worse not better. ~~The evidence for this during the indexing episode of the 1970's is clear;~~ the inflexible government wages by assuring a government deficit in 1930, 1931, and 1932 offset part of the effect of the sharp decline in investment in profits.

The experience of 1929-33 shows that the more prices and wages fell the worse things got; as prices and wages fell precipitiously unemployment increased rather than decreased. If ever there was persuasive evidence that a theoretical construct misspecifies the reactions in the economy, the behavior of prices and real aggregate demand in the period 1929-33 constitutes such evidence with respect to the real balance effect. In operational time, the time spans relevant to human life and political decisions, the ~~speculative~~ demand for money ~~in the sense of Keynes and~~ the need to validate private debt and capital-asset prices by realized profits flows and an as-

surance of continued profit flows, both of which tend to lower demand clearly dominate any tendency for the real balnce effect to raise demand when prices decline rapidly as in 1929-33. The behavior of the price level and money wages in 1929-33 was consistent with the preconditions for the real balance effort to sustain demand: 1929-33 consittutes a test of the in fact relevance of the neo-classical system.

The neo-classical synthesis fails the test of history. The view that money is a particular type of bond that finances activity, rather than the view that money is one kind of eternally valid voucher whose supply is externally seems relevant to an explanation of what happened in 1929-33. Because of the nature of money and the financial system the financing of private activity through the banking system decreased rapidly and the effective terms for financing activity increased sharply over this period.

Classical economic theory has no place for the proposition that normal functioning (coherence) of the economy requires that prices be such as to generate surpluses that are large enough to validate debt and to sustain the prices of capital-assets. This condition is necessary for sufficient investment to take place to generate the profits that validate debt. The validation of debt implies that cash flows from debtor firms to creditors. In 1933 the required cash payments from corporations and other debtors reflected the financing conditions and investment goods prices of the past-when as we have seen substantially higher prices ruled. However the surplus that validates debt has to be extracted by mark ups on out of pocket costs measured in current prices. Thus the fall in prices and wages between 1929 and 1933 increased the required mark ups on prime costs even as

competitive pressures with excess capacity tended to force reductions in percentage mark ups. The burden of the inherited debts increased, and these increased debt burdens were a barrier to speedy recovery in the 1930's.

One obvious fact of life to the Roosevelt era economists and politicians was that the private indebtedness contracted in the ~~property prices of the~~ "prosperous 1920's to 1933" was a factor in the depth of the decline and a barrier to recovery after 1933. ~~and that~~ Furthermore every decline in prices exacerbated the situation. ~~even though~~ Such an overindebtedness view had no rationalization in classical economic theory. ~~This view~~ Overindebtedness as a factor in the Great Depression was documented and expounded in a series of research and policy studies by the Twentieth Century Fund[1]. These studies concluded that "Our debt difficulties were not the sole cause of the great depression, of course; nor was the depression the sole cause of our debt difficulties. But debt contributed to the lack of balance from which the depression came; and it was largely the weakness of our debt structure which made it possible for the business decline to go to ~~such~~ so unprecedented length." (Debts and Recovery p.254).

Institutional reforms of the Roosevelt years were based upon two propositions that emerged from the Twentieth Century Fund ~~studies~~ and other similar ~~work.~~ studies. The proposition ~~that~~ that emerged from these studies and which served to intergrate and rationalize the structural policies of the Roosevelt years were (1) that wage and price levels should never again be so flexible that they could fall as quickly and as far as they did between 1929 and 1933 and (2) that controls on the speculative and fraudental use of debt were necessary.

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[1] The Internal Debts of the United States Edited by Evans Clark assisted by George B. Galloway. The MacMillan Company for the Twentieth Century Fund New York 1933

Twentieth Century Fund: "Debts and Recovery" [The Factual Findings by A.G. Hart, The Program by the Committee on Debt Adjustment] The Twentieth Century Fund New York 1938.

Running through the Twentieth Century Funds Committee on Debt Adjustment recommendation were proposals to reduce the use of debt, to broaden the eligible asset lists for savings banks and life insurance companies to include the equities of "companies having no substantial bonded debt " (p.257) and to tie the life of debts, such as mortgage debts and bonds, to the expected economic life of the asset. It must be remembered that the fully amortized fixed interest rate mortgage which is now our ~~universal mortgage~~ most common form is very much a creature of the Great Depression reforms.

The Twentieth Centruy Funds Committee on Debt Adjustments was advocating structural reforms that would bias the economy towards the use of hedge rather than speculative finance. Many of the detailed recommendations of the Twentieth Century Fund sound very modern and up to date: What is missing from the analysis and policy recommendations in the Fund was an understanding of how the events of 1929-33 were a normal functioning result of the workings of our economy.

Because of the lack of a serious theory of how financial instability is a result of normal functioning of our type of economy, the explanation of the financial instability of 1930's that guided policy centered around fraud, deception, and human error. Many of the financial reforms, both of banking and of the securities business centered around the prevention of fraud and deception. The Securities and Exchange Commission, The Holding Company Act, and the separation in the Glass-Steagall act of commercial and investment banking all reflect an attempt to make fraud and deception, if not impossible, more difficult.

Human error is ~~more~~ difficult to prevent but one can always "lock a barn door after the horse is stolen". One aspect of the decline that attracted

much attention was the spate of bank failures leading up to the virtual total collapse of the banking system in 1933. The Federal Reserve with its concern for its own liquidity and solvency did not step in and support the commercial banks by means of a wholesale open ended purchase of their assets. As a result of this failure ~~by the Federal Reserve - a failure bases upon a fundamental error in conception-~~ the lender-of-last resort function of the Federal Reserce was split into two parts. One part is the deposit insurance function which is exercised by the Federal Deposit Insurance Corporation and the second part is the Federal Reserve responsibility as the "controller" of the money supply.

As is evident from the story told in Chapter 3?, the lender of last resort function with F.D.I.C. in place requires first of all an initial availability of funds from The Federal Reserve discount window and then a "funding" of the "bankers" indebtedness to the Federal Reserve by the F.D.I.C.. Furthermore the F.D.I.C.'s ability to fulfill its part of the two step operation depends upon its ability to raise "funds" by selling Treasury Securities or borrowing. If the operation is large this depends upon active intervention by the Federal Reserve. It is evident that the F.D.I.C.'s ability to carry out its automatic lender of last resort operation depends upon prior and concurrent action by the Federal Reserve. It is also evident that the Federal Reserve could do the job of deposit insurance without the F.D.I.C..

It is perhaps worthwhile to conjecture why the Federal Reserve dithered while the economy crumbled. One reason is that there was no theory of why a financial crisis occurred and how much a crisis grew out of and affected system behavior. There also was no theory relating Lender-of-last operations

to the continued normal functioning of the economy. But perhaps more important than the lack of a theory was the dual responsibility of the Federal Reserve which was to act as a controller of economic activity by controlling the money supply.

The Federal Reserve has always been concerned about being an engine of inflation and even though the record shows that the Federal Reserve does poorly in fighting inflation it is always defining the problem of the day as fighting inflation. A jump in logic made inflation, which according to the quantity theory results from too much money, identical with the creation of money at too rapid a rate; increases in the money supply becomes inflation rather than increases in the price level. The successful execution of the lender-of-last resort responsibility in the situation of the late 20's-early 30's would have required a large scale increases in the reserve base. This would have meant that the money creation potential of the banking system was increased and these potential increases was translated into inflation. An anti-inflation bias made the Federal Reserve stand aside and let nature take its course. It was the ineffectiveness of the Federal Reserve in fulfilling lender-of-last resort responsibilities in 1929-33 that led to today's complicated structure of Federal agencies dealing with banking.

One aspect of reform should be to simplify the structure of organizations that deal with the banking system and financial intermediaries.