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Why 1987 is not 1929

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Business profits are the main driving force of any type of capitalist economy. In modern big government capitalism the stock market is not as closely linked to the determination of business pofits as in the small government capitalism of 1929-33. The stock market shake out of 1987 is likely to usher in a recession, but unless it is compounded by utterly foolish policies, such as cutting spending and raising taxes in order to cut a recession induced deficit, it will not trigger a depression.

In the small government capitalism of 1929 business profits, as a first approximation, were determined by investment. In our current big government capitalism profits, again as a first approximation, are jointly determined by investment and the government deficit.

The great decline of stock prices over 1929-33 was paralleled by a like collapse in the prices of capital assets (factories and machinery), farm land, and housing. It became far cheaper to buy a factory or a house from the stock of idle factories and empty houses than to order a new one built. This led to the collapse of investment and with investment, profits.

In 1987 the sharp fall in stock prices is likely to lower sales of big ticket consumption goods and prices of capital goods, houses etc.. Firms will react by lowering planned investment. Aggregate profits will fall and a recession or a growth recession is likely to start. But in our 1987 economy a decline in incomes from what had been expected automatically leads to a substantial increase in the government deficit, which assures that profits will not collapse. As a result the fall in the prices of capital goods and equity shares will be contained.

The deep recessions of 1974-75 and 1981-82 are models of how our economy is stabilized. In these serious recessions profits were higher in the quarter with the highest unemployment rate than they had been when the recession began. The answer to the question "What do successful stabilization policy stabilize?" is "profits".

In spite of the great increase in the weight of government in the economy, what happens on Wall Street stll has a major impact in determining whether our economy progresses, stagnates or declines. Keynes put it well when he noted that "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the 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." Enterprise is the placing of money in an effort to achieve a dependable flow of income from productive economic activity and speculation the placing of money in the anticipation of achieving gains from an appreciation of the market valuation of assets.

In recent years financial markets have been dominated by speculation Big players have been seeking gains from changing asset valuations, mainly by way of mergers, leveraged buy outs, and take overs and the mass of investors, either through direct stock ownership or by way of pension and investment trusts, were driven to achieve a maximum short term total return, i.e. to seek stock appreciation.

An economy progresses when financial resources are applied to the creation of better products and production techniques, i.e. to enterprise. But in the 1980's management and bankers used financial resources to create highly indebted liability structures that increased the valuation of companies. But such speculator imposed liability structures inhibits the financing of projects with long gestation periods: this shortening of business horizons puts a damper on enterprise.

In industry after industry resource development the strategy of firms has been put on hold while the market valuation game is played. This has led to stagnating industries, a decline in technical leadership, and a deterioration of international competetiveness.

In the type of capitalism we now have, Wall Street and the stock market exist and matter, but they don't matter as much as they did when government was small. Nevertheless policies that curb speculation need to be developed before a new era of enterprise can take over.

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