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FINANCE CAPITALISM 1986 STYLE

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The specter that is haunting the capitalist world is not Communism, as Marx and Engels had it in their *Manifesto* of 1848. In 1986 the haunting specter is that a financial crisis, in the form of an epidemic of failures of banks, other financial institutions, and ordinary businesses, triggered perhaps by a scandal like that of Ivan Boesky, will usher in a world depression. Among perceptive bankers, portfolio managers, and economists there is a fear that a great contraction like that of 1929-1933 is not unlikely in the near future.

There is little doubt that the vulnerability of today's globalized financial capitalism to a financial crises and a subsequent great depression is much greater than that of the welfare state that was put in place forty years ago at the end of World War II. The welfare state provided a depression free environment in which the profitability of financial experimentation led to an initially local and robust financial structure becoming global and fragile. To escape from today's crisis prone economy, economic relations and institutions need to be developed which facilitate the maintenance of conditions conducive to global stability and growth. This is

likely to require greater international policy coordination and consistency of social policies than has been achieved to date.

Financial "crises" are not new. They have occurred regularly since the beginning of the capitalist era. However the first 20 years after World War II was unique in that no significant financial dislocation occurred. Beginning with the late 1960's contained crises have occurred: recent serious episodes include the failure of the Continental Illinois Bank of Chicago and the debt crisis of Latin America. Effective central bank interventions, largely but not exclusively by the Federal Reserve System of the United States, and Keynesian (contracyclical) government deficits contained these crises.

Because interventions were successful, the capitalist world has not suffered a great depression since World War II. As a result, the progress of affluence, uneven though it may have been, has been an outstanding feature of the past forty years. The question is whether past successes are reliable guides to the future. The evidence indicates that the defences against depressions that worked in the past will not work the next time and that the emerging situation is more dangerous than any of the earlier post war crisis periods.

The present acute danger stems from the globalization of banking, the securitization of credit, a weakened American economy, and the perceived need for coordinated interventions by central banks and fiscal authorities once a global financial crisis develops together with doubt that such coordination will be forthcoming.

GLOBALIZATION

The largest banks in the principal countries along with the leading banks in the smaller countries are now global institutions. These banks not only have assets

and liabilities in their home currency, but they also have assets and liabilities in the currencies of the great financing powers. Although the multinational firms are customers of the global financial institutions, the globalization of finance is not just a reflection the expansion of intrernational business. Rather the globalization of finance is largely a product of the communication and computation revolution which has made the world a very much smaller place.

Even though the dollar has been greatly weakened, it remains the predominant unit in which supranational financing takes place. However in keeping with the greater economic and financial strength of Germany and Japan, the international banks now have "books" (assets and liabilities) in West German Marks and Japanese Yen.

This globalization of banking is complemented by the globalization of portfolios. Diversification among financial assets that are liabilities of businesses and government units in a variety of countries is now a common characteristic of individual and institutional portfolios. The great overshoot of the dollar's value in the past several years reflects changes in the portfolios of the rich throughout the world to include a greater proportion of dollar assets. The movement of international capital to the United States was responsible in part for the exchange rates that made United States manufacturing non-competitive in the United States, as well as in the rest of the world.

In a like way, as the rich in the United States and American portfolio managers discover the virtues of offshore assets, the dollar is likely to depreciate too much. This overshoot will improve the competitive position of American outputs. The swings in exchange rates that shifts of financial funds from one currency to another bring about are greater than what changing trade patterns would bring about. To date the globalization of finance is disruptive of trade

patterns. It might be necessary to reestablish a semblance of fixed exchanges in order to moderate the swings in exchange rates.

A little noted but major implication of the globalization of both banking and portfolios is that financial practices are rapidly becoming similar throughout the capitalist world. The current debt crisis of the Latin American and other poor countries has made it clear that there are great risks in lending to sovereign bodies. For much of the world the global financial system is now more hospitable to asset and firm risks than to sovereign risks.

This means that the countries of the world are under market pressures to change their corporate law and their tax systems to a common standard. The exchange value of a country's currency and the availability of financing for its industry increasingly depends upon its ability to generate financial instruments that are acceptable on international financial markets.

Even though the globalization of finance is likely to be interpreted in the press as a new form of American dominance, nowhere will the loss of national autonomy be more apparent and harder for the politicians and public to accept than in the United States. The way things are developing, in the not too distant future United States policies that are deemed dangerous to asset values are likely to be greeted by a flight from the dollar.

The Mitterand policies in France were frustrated by a flight of capital from France that led to pressure on the franc, inflation, and a recession. In a similar but less acute form even now there is widespread distrust of United States fiscal policies among the managers of international portfolios. The current apparent overshoot in the decline of the dollar may reflect this distrust. The United States

has lost a measure of the fiscal independence that was so evident over almost all of the post war era.

SECURITIZATION

Banks and other depository institutions interpose a guarantee between their debtors and depositors. There is a rapidly growing financing technique, securitization, by which banks and other financial institutions package assets into collateral for notes and bonds that underwriters then sell on the global public financial markets. Securitization involves separating the financing process so that different units create, enhance, and hold financial instruments. In a securitized credit the holder of the security has recourse only to the collateral and whatever provision was made for enhancing the credit to protect at least some security holders in the event some of the collateral defaults. With appropriate legal arrangements these securitized instruments will facilitate the globalization of finance.

This new way of doing the business of banking reflects the emergence of institutions that can finance the holding of more financial instruments than they can create. Among such units are foreign banks that do not have detailed business connections in a country, money market funds, pension funds, and insurance organizations. Because the final holders of the securities typically will acquire the paper only if they are protected against both fraud and losses, trustees and institutions that enhance or guarantee the quality of credits are part of the emerging financial structure. A division of labor is emerging in which in each country's domestic banks are creators of paper and global banks and portfolios are holders of paper.

Securitization leads to problem and nonperforming assets being concentrated in banks and other institutions that originate and guarantee loans. Only assets that are performing and whose quality has been enhanced by some guarantee can be used as collateral for securities. Although securitization expands the financing available during good times, the specter that haunts observers is that this new financing technique will make things worse when a downturn occurs. Whereas deposit liabilities enjoy the enhancement due to bank capital and the guaranteed protection of banks by central banks, these new security instruments do not.

As a result of securitization nonperforming and unenhanced credits will be concentrated in banks and other depository institutions that are protected by government agencies. This implies that the need for deposit insurance funds and central banks to absorb losses and refinance failing institutions is likely to increase. Although the expansion of securitization may have been a result of deregulation, the final effect may well be to increase the need for intervention.

THE WEAKENED UNITED STATES

As late as 1984 the Federal Reserve was able to contain the effects of the failure of Continental Illinois Bank without overt assistance from other central banks. Most likely this cannot be replicated. In the present globalized financial structure, intervention to contain the damage from a big bank or other major failure is likely to require cooperation among central banks.

The two towering deficits of the United States of the last five years - the \$150-200 billion deficit in the Federal Government's budget and the similar deficit in the United States' trade account - are major causes of the fear in international financial circles. These deficits have greatly weakened the global economic power of the United States. It is recognized that during 1946-1980 when the United

States was the world's dominant economic power it used its power rather well to stabilize the world economy.

This beneficent use of economic power was not the result of altruism. The prevention of a serious recession in the United States by running appropriate deficits and containing the destabilizing forces within the domestic financial structure was in the United States' self interest. The positive effect on the world economy was a side effect.

Experience and economic theory alike show that for capitalist economies to run reasonably well interventions by government agencies to prevent runaway financial collapses and to sustain business profits are necessary. In order to do this, the government has to be able to run needed deficits when private investment loses its "steam". The ability to run such deficits now requires that government liabilities be accepted in the global financial market. Acceptability in the market of a governments debt depends upon a belief that there will be either actual or close approximations to a budget surplus in the future.

In today's global financial structure public and private liabilities of United States entities need to be accepted in the global market. In the longer run the acceptability of the public debt depends upon the adequacy of tax revenues. The international consensus is that the United States has to truly reform its tax structure so that the revenues are adequate for its responsibilities.

In particular the United States cannot continue to run a large deficit when the business cycle is at a peak. Peacetime deficits need to be reserved for recessions. For the United States government and its central bank to be able to act as economic steering wheels, a tax system is needed which raises sufficient

revenues to cover spending in good times. The absence of a match between the tax system and the spending programs is one cause of the fear that is prevalent.

THE NEED FOR COOPERATION

The importance of the two great surplus countries - Japan and West Germany - in the international financial community has increased as the United States deficit in international trade has led to their accumulating dollar assets. The next time central bank intervention is needed to contain an emerging financial crisis the Japanese, West German, and the United States' central banks will need to cooperate. There is real fear that this cooperation will not be forthcoming.

One reason for this fear is that international cooperation has not been forthcoming to contain the United States' deficit in its international accounts. The problem of the United States' international accounts is often stated in terms of the inability of American manufacturing to compete because wages are too high. These high wages support the much advertised American consumption standards. The other side of the too high coin is that consumption standards in Japan and to a somewhat lesser extent in West Germany are too low given the productivity of their economies.

In each capitalist country the mass of profits available to business is determined by its domestic investment, government deficit, consumption standards, and balance of payments surplus. The Japanese and West German economies depend upon their foreign trade surpluses for their overall profitability to too great an extent. They maintain a high saving ratio by depressing consumption. The world economy cannot achieve global prosperity as long as the Japanese and German social structure and distribution of income lead to low consumption standards.

The required transformation from a low to a high consumption economy requires a great transformation of Japan's economic and social structure. There is little evidence that this is understood and there seems to be no willingness of the Japanese to make the necessary changes.

History indicates that fundamental economic reforms take place when the economy is not working well. It is likely that the Japanese economy will have to go through a crisis before the transformation will take place. But a serious enough crisis in the Japanese economy to prompt fundamental change may need to be preceded by a severe world recession.

IDEALOGISTS AND EFFECTIVE POLICY

Another reason for apprehension is that the Paul Volcker era at the Federal Reserve is coming to an end. The new appointments to the Federal Reserve from the Reagan White House tend to be ideologues who have pre-conceived ideas about what should be done. They are not pragmatists who have a serious understanding of the way the ever changing globalized banking system functions. If Volcker's successor is like the recent appointments, the United States will not have the weight in the international financial community it now has. The leadership Volcker gave will be missed whenever a crisis develops.

There are ample reasons for pessimism about the near future of the world economy. The globalization and securitization of finance has undermined the effectiveness of the system of interventions that served us well in the post war period. Nevertheless the worse that could happen need not happen.

The structure of big government in the United States and Europe has not been dismantled. This means that the global collapse of profits such as happened after 1929 will not happen. Furthermore the professionals, if not the politicians,

in the world of high finance are aware that the global financial structure requires a global system of support.

Thus the global financial structure points to stormy weather, but not to a replication of 1929-33. Government would have to shrink by a large factor before the danger of another 1929-33 becomes acute. The only way this could happen is if large scale disarmament takes place. It is ironic, but the Soviet Union may have the power to threaten the life of capitalism by kindness.