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Introduction

The existing international monetary regime is unsatisfactory because

1. An effective international division of labor among the rich countries is frustrated by large exchange rate swings,
2. "normal" flows of investment resources from the high to the low per capita income countries are not taking place, and
3. economic growth for many countries, both socialist and capitalist, is blocked by the payment commitments due to international indebtedness.

The great exchange rate swings among the rich countries are due mainly to the movements of money motivated by prospects of gain on the financial markets: factoral comparative costs cannot move as rapidly as exchange rates have moved. The international indebtedness that is acting as a barrier to the growth of poor capitalist countries, such as those of Latin America, may be as much due to international portfolio diversification (capital flight), which leads to the rich in poor countries owning financial assets based on the economies of rich countries, as it is to the cumulative effects of the poor countries' production and trade problems.

Successful international monetary reconstruction will have to confront

1. the emergence of managed money capitalism,

2. the need for symmetry between trade surplus and deficit countries in adapting to balance of payments disequilibria and

3. the unequal distribution of fiscal independence among countries.

Managed Money Capitalism

Position taking block traders withdrew from the market as the crash of October 19 and 20, 1987 developed. On Tuesday October 20 Corregan, President of The Federal Reserve Bank of New York, and other officials intervened and induced these position takers to resume their activities. Upon their return, the market once again functioned with relative tranquility. This direct intervention combined with traditional Federal Reserve measures to generate monetary ease calmed the markets so that after nearly dying at noon the market closed with a significant gain.[1] Ten months later, in August 1988, it seems as if the crash was no big thing for income and employment seem not to have been affected.

The crash and how it was contained draws our attention to the way the financial structure of 1988 differs from that of 1948 and 1968. It is a common place observation that the

1. Wall Street Journal November 19, 1987

Robert M. Giordano, "The Federal Reserves Response to the Stock Market Crash" Economic Research, Financial Market Perspectives, New Youk, Goldman Sachs December 1987.

world's financial markets are more global now than ever before, and the events of October confirmed this view. The new idea that the October episode underscores is the emergence of managed money, which makes the managers of money leading players in financial markets and in determining the course of economies. A shift of weight in the financial world from institutions, such as banks, to markets for stocks, bonds and sophisticated combinatorial or synthetic instruments has taken place: banks are of smaller importance relative to the fund managers in 1988 than in 1968 and 1948. (Some banks, such as Bankers Trust and Morgan Guaranty are very important fund managers. This muddies up the above assertion.)

The change from institutions to markets as main players accelerated when the credit crunch of 1966-67 ushered in an age of financial turbulence, inflation and deregulation that weakened banks and other depository financial institutions. As a result the attractiveness to portfolio managers of market based financial instruments increased relative to financial intermediary liabilities.

The new money manager financial structure is based upon mutual, pension and trust funds. These funds are arrangements through which the ultimate beneficiaries delegate the management of their wealth to some agent - a money manager. These funds, whose very existence depends upon the success of the economy in avoiding deep depressions, have given birth to power relations which have changed the behavior of capitalist economies. A new managed money capitalism is challenging the dominance of managerial - welfare state capitalism: managers of money are replacing managers of industry as the leading players in the economy.

The dominant trait of money manager capitalism is that individual "savers" or wealth owners have "positions" in funds such as pension funds, mutual funds, insurance reserves or bank managed trusts. These funds are managed by professionals who seek to maximize total returns (cash flow plus asset appreciation). This managed money is volatile across instruments and international boundries.

If the reconstruction of the international monetary mechanism is to be successful in creating a financial environment that will promote an efficient international division of labor and generalized economic growth it will have to deal with the significantly greater importance of international portfolio diversification that characterizes money manager capitalism: multinational corporations are of lessening importance, multinational portfolios are of increasing importance.

Because of the links among financial markets brought about by portfolio movements, the course of exchange rates in the short and intermediate terms is more dependent upon current portfolio choices than upon current trade balances. (The uptick of the dollar in late June and July was due to portfolio choices that were being made: The United States' trade deficit though improving was still in deficit by a great amount.) Portfolio choices of money managers drive exchange rates; the balance and terms of trade can change all out of proportion to changes in relative production efficiencies. Much of America's industrial decline of the early 1980's was a creation of a grossly overvalued dollar that resulted from interest rate differentials, safe haven portfolio choices towards the dollar, and speculative momentum rather than due to a sudden deterioration of America's comparative factorial production costs.

Modern capitalism is characterized by the corporate form of organizing business and complex financial structures which include tradeable instruments. By means of debt and equity liabilities corporate managements control the real capital assets of the economy: the financial instruments distribute present and future gross profits earned by firms to various claiments.

Tradeable financial instruments have explicit prices that are determined in markets that are interdependent with markets for labor and current output. Capitalism is characterized by two sets of prices: those of current output (and labor) and those of capital and financial assets. The behavior through time of capitalist economies depends upon how these two sets of prices, whose proximate determinants are quite different, vary one with respect to the others.

A commandment for creating economic theory that is relevant for capitalist economies is: "Thou shalt not dichotomize" between a the presumably real and the financial spheres of the economy. Theories that claim to tell us about the behavior of market economies by first ignoring money and finance and then considering the influence of these variables will not, in general, advance our knowledge of capitalism.[2] The price specie flow mechanism to explain the balance of payments adjustment process is a dichotomised analytical structure in which the financial variables passively accomodate the active real terms of trade. To the extent that a trade primacy model guides the reconstruction of the international monetary mechanism, the reconstruction will not succeed.

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2. This was the essential message of Keynes, but the derivation of a theory that integrated money and finance with the determination of prices and outputs was the objective not only of Keynes but also Schumpeter, Mitchell and other giants of the 1930's.

Joseph Schumpeter, Ten Great Economists, New York, Oxford University Press, 1951 - Chapter 9, Wesley Clair Mitchell.

H. P. Minsky, John Maynard Keynes, New York Columbia University Press.

J Kregel, "Money, Expectations and Prices in Keynes' Monetary Equilibrium", Economie Appliquee No 3, 1982 Vol 35.

"The Changing Place of Money in Keynes's Theory from the Treatise to the General Theory", in Keynesian Theory Planning Models and Quantitative Economics, Ed. G Gandolfo and F. Marzano 1987

A common attribute of capitalisms is that the proximate owner and operator of capital assets has typically sold equity shares and borrowed money to finance production and the control of capital assets: to paraphrase Justice Louis Brandeis _other people's money_ is used by owners and managers. In the capitalism of 1946 to say the 1970's or so the borrowing of business was predominately from banks or other financial intermediaries: in such institutionalized intermediation the _other people's money_ was the deposits in the bank or the policyholder's cash value.

This _other people's money_ was mingled in the lending with the ownership interest in the intemediating financial institution. The legal status was such that the ownership interest protected the depositor by absobing the first tranche of portfolio losses. Bank and other financial institution equity "enhanced" bank deposits.

A particular attribute of today's capitalisms is the use of _other people's money_ has now become much more widespread and has taken on new dimensions. Whereas in earlier days the invester in shares and bonds commonly invested his own money now, to an ever greater extent, the proximate invester is a pension or mutual fund or some bank trust department. The proximate invester is placing pension or mutual fund monies that are in trust for some designated body of beneficeraries. Both the manager of the enterprize and the proximate investor are playing with _other people's_ money, but the liabilities of the trusts are not enhanced by equity supplied by the money manager.[3]

This new stage of capitalist evolution can be labeled managed money capitalism, and it is the trading activities of the money managers that have given rise to the exotic instuments and activities such as program trading and portfolio insurance. One aspect of managed money capitalism is that the huge holdings by the trusts and funds cannot be traded on the public markets: The J.P. Morgan Investment Trust does not deal in 100 share lots of Texico: the trading unit might well be shares worth a million dollars. Trading in the assets of these funds requires the intermediation of block traders who buy large lots of securities and dispose of them in smaller lots or find other funds that want to take a position in the securities. Incidently block traders use their firm's funds in taking positions. As was shown on October 20, units that use their own funds are apt to become risk averse in a market where losses have taken place.

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3. The struggle between the management of Texico and Carl Icahn for the control of Texico brought some of the dimensions of managed money capitalism to the fore. There were some 243 million shares of Texico common stock outstanding. Icahn owned some 14.8%, major institutions (managed money) 38.3%, arbitragers 6.2% and Texico employees,directers and officers 6.0%. Individual investers owned some 20.0% (The New York Times, Saturday June 18, 1988)

Among the major institutions J.P. Morgan Investment Management held over 5 million shares, College Retirement Equity Fund some 3.9 million shares etc. At the price of June 17 the shares controlled by Morgan would be worth about 1/4 billion dollars. (The Wall Street Journal, Friday June 17.)

The international dimension of the movement from institutions to markets for financing is that the export and import of capital increasingly takes the form of the purchase of managed funds and international portfolio diversification by managers of money. As money manager capitalism grows in importance the same portfolio options will become available to all wealth holders regardless of their national "base". The exception to this will remain where private knowledge makes the direct ownership and operation of capital assets by insiders (nationals) superior to the operation of capital assets by outsiders: national own and operate options will remain.

In a developed international managed money capitalism insiders will be able to take advantage of their position only as they are able finance their activities by issuing instruments that are competetive with international instruments in yield and security. The need for liabilities to be competetive remains even though differences in the currencies of denomination of liabilities gives some financing advantage to enterprises who earn income in the same currency as the obligations of the financing funds are denominated. In a financially integrated world, where options for international portfolio diversification are universally available, each enterprise needs to issue instruments that are attractive for the portfolios of professionally managed funds no matter where in the world the issuer and the prospective purchaser may be domiciled.

In a mature managed money capitalism enterprises and governments of the various countries will have to create instruments that are attractive to market participants. The securitization of debt and even of equity instruments is one possible model for how instruments can be created that can provide portfolio diversification opportunities for assets based upon a particular country's economy.[4]

In managed money capitalism international monetary reconstruction will be successful only as participating economies generate attractive instruments for managed portfolios. Under managed money capitalism international financial integration requires that the legal codes of the countries that supply instruments for international portfolios be compatable.

Symmetry

Once international portfolio diversification is a major part of the international monetary and financial picture significant cross national cash flows arise from the fulfillment of financial contracts; furthermore each contractual cash flows is denominated in some particular

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4. For securitization and international financial relations see:
H. P. Minsky <u>Global Consequences of Financial Deregulation</u>, Marcus Wallenberg Papers on International Finance, Vol.2 no.1, Washington D.C., International Law Institute and School of Foreign Service, Georgetown University,1986.

currency, which need not be the currency in which the income supporting the payment commitment is earned. A need to exchange currencies arise from financial linkages: a country's international financial position can be viewed as a prior commitment of its earnings on trade account. In a domestic credit arrangement, where the lending bank takes its resposibilities to solicit, structure and supervise credits seriously, lenders often intervene to facilitate the earning of funds required to enable the borrower to fulfill payment commitments.

The stablilty of the international financial structure and its compatability with wide and sustained international growth depends upon the balance of trade of the economies which have large positions in assets based on other economies. Countries whose citizens and institutions have large net holdings of offshore income earning assets need to run chronic deficits in their trade account.

A key part of any viable international monetary system is a symmetry of adjustments between the trade surplus and trade deficit economies: the gold standard rules of the game provide such symmetry. The Keynes plan by requiring surplus countries to acquire markers that yielded no income also provided such symmetry. In an integrated financing and trade system the symmetry can be enforced by imposing international barriers to the exports of fiscally independent countries that persist in maintaining export surpluses. Another possible way of enforcing symmetry is by requiring all international financial linkages to be denominated in the debtor's currency, forcing the exchange rate risk upon the lender.

Every debt within a country, except perhaps for sovereign debt, provides for a way in which the debt can be cleared by forfeiting assets, by allowing the creditor to capture some underlying assets. This is a way of sharing the costs of poorly structured financing, recognizing that lenders as well as borrowers have a responsibility in structuring financial relations.

Fiscal Independence

I want to introduce a concept "fiscal independence".[5] An economy is fiscally independent when there is a significant net cash flow per period to the economy from its ownership of offshore or foreign assets. For a fiscally independent economy there is a large entry "net income from offshore assets" in its balance of payments. Britain before World War I is a model of a fiscally independent economy [6] Given the financial linkages among countries that are sure to grow in managed money capitalism, rules of behavior for

5 My memory is that the concept is due to Pier Jackobsen, but I cannot trace it down, memory and library deficencies. If any reader can help I will be grateful

6 R. S. Sayers <u>Bank of England Operations 1890- 1914</u>, London P. S. King and Sons, 1836 is the source of my views about the tiers that make up the balance of payments.

fiscally independent economies need to be explicitly developed in any scheme of international monetary reconstruction.

Fiscally independent economies need to be under injunctions by international agrreement to run deficits in their trade accounts: this deficit to be an increaing percent of its income from offshore assets as such income grows. If a fiscally independent economy's currency is also an international reserve currency then it should also be under an injunction to invest more abroad than the difference between its foreign income and its deficit on trade account. The fiscally independent economies should invest more abroad than its current surplus from trade and asset income by financing a part of its long term investment abroad by short term borrowing from abroad. This financing short creates liquidity for the debtor countries and allows its banking system to expand local financing.

A country with fiscal independence that persists in running a strong surplus in international trade is beggering its neighbor, i.e. achieving prosperity by impoverishing its trading partners. The constitution of a reconstructed international monetary system should recognize that trade discrimination against a fiscally independent economies that persist in running surplusses on trade account is a legitimate weapon to promote an efficient international division of labor.

There are complex problems of determining when an economy is fiscally independent and when an export surplus is beggering neighbors. However to give an example if a fiscally independent economy is running a global surplus as well as a surplus with the United States it might well be barred from acquiring assets in the United States, but not barred from investing in say Argentina or Mexico.

Conclusion

The weakness of the fluctuating exchange rate system that now rules is that it assumes a trade only world in which small changes in relative prices due to exchange rate variations lead to large changes in supply prices and to large changes in demand when own currency price changes. In truth the world is not characterized by such elastic demands. There are financial flows which dominate trade flows in determining short term movements in exchange rates and these "short term" movements last long enough and go far enough to radically change exchange rates, destroy industries and to quickly create large international financial links among economies.[7]

The problem of financial linkages and how they affect any prospective new international finacial regime is much

7. H.P. Minsky, "Secrets of the Temple: How the Federal Reserve Runs the Country: A Review Article", Challenge Magazine, May/ June 1988.

too broad to be covered in a short introductory comment. Enough to say that any serious reconstruction of the international financial structure will have to acknowledge the nature of international financial linkages in modern managed money capitalism, set up mechanisms so that economies with balance of payments surpluses carry more of the costs of adjustment, and recognize the special resposibility for international economic growth of the fiscally independent economies.