Finance and Stability: The Limits of Capitalism

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Paper prepared for a Conference
"The Structure of Capitalism and the Firm in Contemporary Society"

Milan Italy
March 18th-20th 1993.

March 3, 1993
Preliminary
The call for this conference reads "When the whole world, so to speak, is capitalist it is timely and useful to question the limits of capitalism, its ability to provide answers to new contemporary problems, and the scope for intellectual innovations capable, to some degree at least, of remedying such limitations."

I participated in a Conference on Financing Prosperity in the 21st Century at my home base, the Jerome Levy Economics Institute of Bard College in Annandale on Hudson New York, on March 4, 5, and 6. March 4 1993 was the 60th anniversary of the inauguration of Franklin D. Roosevelt as President of the United States and March 6 was the 60th anniversary of the American bank holiday.

The popular description of the bank holiday is "Roosevelt closed the banks." That is not true. By March 4th 1933 the banks in some 30 states had been closed by the Governors of the states and as he was being inaugurated as President on Saturday March 4 Roosevelt was informed that the New York banks would not open on Monday March 6. The bank closing was a preemptive strike - it was forced upon Roosevelt. It also moved the solution of the problem of illiquid and insolvent banks and other financial institutions from the Financial Community to the Federal Government.¹

¹ In the crisis of 1907 the House of Morgan played a central part in resolving the crisis. In the crisis of 1933 the government through the Reconstruction Finance Corporation played the central part in resolving the crisis.
The bank holiday was the climactic event of a great contraction of the American Economy that began in October 1929 and lasted until March 1933 - more than 40 months of decline. The decline was not only long but it was also deep. Output fell by about 33%, prices fell by about 33%, and the indices of stock prices (The Dow Jones or the Standard and Poors) fell by some 85%.

In a country where 1/3 of the labor force was in agriculture in the winter of 1932/33 unemployment was at least 25% of the labor force. Independent dairy farmers in Iowa and Illinois were blocking the highways to prevent milk from reaching the market.

Sixty years ago capitalism was a failed economic order in the United States and throughout the world. Today as the call for this conference notes "the whole world is capitalist". We have to address the following questions

1) "What flaws made Capitalism a failure in 1933?",
2) "What turned a failed system into a success?" and
3) "Were the Capitalism that failed and the Capitalism that succeeded the same economic order?".

Even as we celebrate the "victory" of capitalism we are aware of the current problems or even the current crises of the hitherto successful post war capitalisms. While the capitalisms of the United States and Western Europe may have been very successful societies during the first two decades after the second world war ended, their performance the last decade and a half to two decades falls short of the standard
that was achieved earlier. Japan which seemed to have escaped many of the problems besetting the United States and Western Europe in the 1980's now seems to be suffering from the same "virus" that affected The United States and Europe. We add two questions to our list:

4) "What attenuated the success of the early post war capitalism?"

5) "Why are the welfare states of the post war world now in crisis?"

We need to recognize that one reason capitalism won and the Soviet version of Socialism lost was that the Lenin Stalin version of Socialism allowed for only one form, the highly centralized linear command model, whereas, as the call for this conference recognizes, capitalism comes in many forms. At one time the slogan of the Heinz pickle and ketchup company was "57 Varieties". In America, when I make the point about the varieties of capitalism I often say that "There are as many varieties of Capitalism as Heinz has of pickles."

The successful Capitalisms of the 1950's and 1960's were not the same as the Capitalisms that failed in the 1930's. I venture to assert that the successful capitalisms of the 21st century will be even another form of capitalism.

Reagan and Thatcher tried to over throw the welfare state that was the inheritance of Roosevelt and Atlee (and Sweden as the famed middle way). In the United States the major substantive change of the Reagan years in the economy
was the destruction of the revenue system and the emergence of an economy that was structurally dependent upon government deficit financing of a budget that was mainly devoted to support military spending and consumption. After a spurious prosperity, largely based upon an unproductive government deficit, an enormous expansion of the financial services industry and Ponzi financing schemes that left the country with an excess supply of office structures, the Reagan Bush years saw the economy of the United States stagnate and burdened by an even more inefficient pattern of spending because of the great expansion of the government deficit.

Clinton in his still new administration is trying to invent another "new" form of capitalism, a capitalism which does not categorically reject the central concept of the new capitalism of the early post World War II, that effective capitalism requires a large government sector, but rather builds upon it by shifting the focus of government spending from financing defense and consumption to financing resource creation.

6). "Can we discern the general outlines of a new capitalism that may emerge in the United States?"

I have raised 6 not independent but rather overlapping questions. I now have to move on and try to answering them. The first question we need to address is what are the flaws of capitalism made capitalism a failure in 1933 and are these flaws permanent characteristic attributes of
capitalism? Then we will address the question of what turned the failed system into at least a transitory success.

One striking flaw of capitalism - which was identified by Marx and Keynes - is its inability to maintain a close approximation to full employment over extended periods of time. Keynes recognized that capitalism is not merely a market economy: it is also a financial system. The fundamental aspect of Capitalism is that it is an economic order in which there are two sets of prices. One set consists of the prices of current output and the other set consists of the prices of assets, both the capital assets used by firms in production and the financial instruments that firms issue in order to gain control of the fixed and working capital they need.

The financial instruments issued by firms are held by households and financial institutions such as banks. Ever since the corporation became the dominant form for the organization of business the financial instruments issued by firms include equity shares as well as various forms of debts. The equity shares and some of the debts are freely traded on public markets: these instruments market value depend upon publicly available information. In practice it

2. In a modern economy household and government debts exist and are held by financial institutions and directly by households. These other liabilities complicate the cash flows and offer routes which can dampen and amplify the effect of the debt structure on the performance of the economy.
is the market price of shares and debts which form the second price level of capitalist economies, although with the growth of the holding company form of corporate capitalism entire businesses are sold and bought.

In the United States the reforms of the financial system during the Roosevelt era made transparency the overriding principle guiding the operations of corporations and of markets on which equity shares are traded. Other debts of corporations, which do not depend upon publicly available information but rather on negotiation and discovery, are debts to banks and other private placements to other financial institutions. Such debts, which are not marketable are syndicated among institutions such as banks which are knowledgeable about processing private information.

One way of interpreting the security market reforms of the Roosevelt era is that they made the law catch up with the fact that capitalism now was corporate capitalism.

As I pointed out earlier over the more than 40 months of the great contraction the price level of current output fell by 33% whereas the price level of equities on the stock exchanges fell by 85%. In 1933 it would cost 67% of the 1929 price to produce investment output but it would only cost 15% of the 1929 price to purchase a firm on the stock exchange. Similar ratios held for commercial buildings -
office towers etc. If the relative prices of new and old capital assets was less than 1 to 1 before 1929, in 1933 the relative prices of new to old was 4 to 1. In 1933 no one would order new investment output when the second hand market for investment, the market for capital assets, was full of bargains.

In standard economic theory prices are the terms upon which alternative goods and services are available. As the theory is set up all that really matters are relative prices. However to producers in a capitalist economy output prices recapture wage and material costs and carry profits: in turn the profits enable a firm to pay the interest and principle on debts, provide funds for dividends and retained earnings. Inasmuch as debts are almost always denominated in money to producers nominal prices matter. In the markets where assets, financial and real, are traded the prices are the present price of future money flows i.e the nominal value of a firm is a capitalization of its nominal profits.

In a progressive capitalist economy investment outputs are a part of current output. When investment outputs are completed they are assimilated to the stock of capital assets: the investing firm pays the investment producer for the investment good. This payment is made with internal funds (retained earnings), funds raised by the sale of equities and funds raised by debts, either as borrowings from banks or as the receipts from the selling of bonds. At
the moment of purchase the value of a particular investment output changes from being determined by the sales price to being determined by the present value of the future incomes that operating and otherwise using this asset is expected to generate.

No one would use current resources to produce items for the stock of capital assets if the present value of capital assets, as determined by markets which transform expected future profits of firms into the market value of debt and equity liabilities of firms, is not equal to or greater than the price the producers of the investment good need to charge in order to recover the costs of producing the investment good and to earn the profits that enable the investment goods producers to be viable firms. No one can take issue with the above statements. They are straightforward statements of what enters into the behavior of practical operators in a modern capitalist economy.

In a modern rich capitalist economy corporations are the proximate owners and the actual operators of the non-housing, non-agricultural capital stock of the economy and the principal purchasers of investment output: corporations are also the principal proximate recipients of capital income or gross profits.

A capitalist economy can be viewed as a set of interrelated balance sheets and income statements. There are two ultimates in this formalization: firms, which own
the capital stock of the economy, and households, which own the financial liabilities of other units as assets. Financial institutions stand between firms and households. Today to a large extent the liabilities (equities and debts) of firms are owned by financial intermediaries of one type or another and the assets of households are largely liabilities of financial intermediaries.

These intermediaries - banks, savings institutions, insurance companies, and pension funds to identify the most prominent subclasses of the class, financial intermediaries - are self, or profit, seeking institutions. In a modern capitalist economy maximizing behavior is not restricted to households and firms that own capital assets, for the entire array of financial intermediaries seeks profits. Each profit seeking financial intermediary has an agenda of its own: they are not charitable institutions.

Of these profit seeking private agenda financial organizations one set plays an exceptionally delicate role in capitalist economies. This set consists of the investment or merchant bankers who either as brokers - who bring buyers and sellers together - or dealers - who take financial liabilities into their own accounts - act as midwives to the start up of companies and the financing of continuing operations.

Essentially these operators have superior knowledge about their customers who need financing (they have a need for funds) and their customers who have a need for outlets
in which money can be placed. They turn this private knowledge of the conditions under which funds are desired and the conditions under which funds are available to their own advantage, even as they perform the social function of selecting the investments that the economy makes.

These financial intermediaries are of critical importance in determining the values attached to collections of capital assets as collected in firms. In a balance sheet the difference between the sum of the values entered for capital and financial assets and the value of debts on the liability side is the book value of the owners' interest in the firm. Dividing the book value of the owners' equity by the number of outstanding shares yields the book value of a share. However for the main companies in a large economy there is a thick market for equity shares and this market value may be less than, equal to or greater than book value. A main consideration in decisions to invest is that the market valuation of the capital assets needs to exceed the supply price of the investment output, with a margin of safety that allows for the riskiness of the project.

One consequence of the introduction of these layers of profit seeking organizations in the markets which determine the value of financial instruments, is that the value of financial instruments and therefore the value imputed to capital assets can and does vary independently of the cost of investment outputs. Furthermore the extent to which internal funds are available to finance investment depends
upon the excess of anticipated cash flows from operations over the amount needed to service liabilities that were issued to finance such acquisitions in the past.

Because the capitalization rate depends upon present views of the future and the amount of secure assets in portfolios, the ratio of market price of capital in firms to the market price of investment outputs can vary. The very structuring of the argument in terms of a demand for investment output that depends upon the capitalizing of future profits and the determination of the supply price of outputs as dependent upon labor costs of producing these outputs assures that the supply and the demand relations would not, in economist jargon, be homogeneous of degree zero in either money or in money wages. The result would also not be independent of the extent to which positions of market power are capitalized into the price level of capital assets.

Thus the capitalist technique of valuing outputs and valuing capital assets, the market determination of liability structures and the possibility of sharp increases and decreases in the market price of capital assets and financial instruments leads to systematic increases and decreases in the price of assets relative to the price level of current output. This feeds into the amount of investment financed, which in turn leads to the flow of current profits. Once current profits fall by enough so that the cash flows to highly indebted operations are insufficient to
meet commitments on liabilities then the pressure of the need to validate debts and to meet withdrawals by depository institutions leads to a proliferation of attempts to make positions by selling out positions. The result can be a sharp fall in asset values. A downward spiral is a possibility: the end result can be a great or a serious depression.

Thus the flaw in capitalist centers around the possibility of financial crises and the way in which these crises lead to depressions as investment collapses. This flaw cannot be eradicated from the corporate form of market capitalism in which liabilities that are prior commitments of the gross nominal profit flows of corporations.

The new model capitalisms that emerged out of the great depression and the second world war had much larger government sectors than the failed model of the 1920's. Central banks were no longer constrained by the gold standard: they were now expected to use their ability to affect the behavior of banks to sustain income and employment and contain any thrust to an accelerating inflation or a deep deflation. The ability of a country to float its currency was much greater and the responsibility for maintaining aggregate demand by government and even by international cooperation was acknowledged.

For much of the period the sole governor of the international system was the United States' commitment to maintain its domestic economy at a relatively close
approximation to full employment and willingness of the United states to run a trade deficit.

Capitalism failed in 1929 because of the flaw inherent in the two price system nature of capitalism. Capitalism was reconstructed in the 1930's and after World War II with a much greater government sector, which in the United States was largely devoted to sustaining consumption and military spending. Nevertheless private investment remained the major determinant of the increase in productive capacity and the value of private investment still rested upon the price level of capital assets being greater than the supply price of investment outputs. The flaw that over indebtedness can lead to a sharp decline in the ability to validate debts and therefor to a sharp fall in the value of capital assets as collected in firms remained.

The recent history of the United States is a history of a thrust towards a debt deflation that was contained by a combination of central bank intervention and massive government deficits. The contained depression was really a protracted recession which ultimately led to a sharp fall in first short term interest rates that is now, with a lag, being followed by a fall in longer term interest rates. The fall in interest rates led to a rise in the present values of income streams which in turn increased asset values. For the time being the turbulence in financial markets in the United States has decreased.
The failed capitalism of 1929-33 was a small government constrained Central Bank economy. The capitalism that had a good run after the second World War was a big government economy with Central banks that were less constrained than during the inter war years.

The post World War II model of capitalism was so successful over the first twenty + years after the War that some are given to calling that period a Golden Age. While in truth it was not a Utopian Golden Age, each of us can find fault with the economy of the 1950's and 1960's, it might very well be a practical best. On an absolute scale the most recent twenty+ years after World War II were not bad, but they suffer by comparison: however a clear path of deterioration is discernable over these years in part because of policies such as Reagan and Thatcher exemplify, in part because of the way in which protracted success leads to an acceptance of commitments to pay which erode the margins of safety which make capitalist firms and financial institutions resilient.

The junk bond episodes and the commercial construction excesses are built into the way in which business men and bankers interact in a capitalist economy. Only capitalist economies in which the regulatory agencies have stronger and more sophisticated controls than the regulatory agencies have in the United States can avoid the financial excesses
that bring financially complex economies to the brink of collapse.

"Why are the welfare states of post world war II Capitalist economies now in crisis?" is the fifth question. I can answer for the United States. The Social Security system was never adjusted for the enormous increases in life expectancy. If the life expectancies now were as they were 60 years ago there would be no crisis in the social security part of the United states welfare state. The solution to this is rather simple: increase the age at which people retire. However this increases the labor force and therefor there is a need to increase the number of available jobs. Welfare reductions lead to a similar problem: having people now on welfare work enter the labor force increases the number of jobs needed and would likely lead to a rise in unemployment rates.

On both ends of the welfare state scale - Social Security, whose benefits largely go to the well, off and Welfare, whose benefits largely go to the poor - the easy solution requires that the number of jobs increase.

We now live in a world where less than 3% of the United States' labor force is in agriculture and where an ever decreasing percentage of workers can produce all of the manufactured goods that the economy demands. There is a need to support more workers in the production of socially
useful output that is not manufactured goods. In the United States much of such production is by state authorities.

There is a crisis in America which is different in kind than those in Europe. During World War II the United States began job related health care "insurance" and job related supplements to Social Security in the form of pensions that were liabilities of corporations: corporations also took responsibilities for the health care of their retired workers. These pensions were not funded until the 1970's and even now many are only partially funded. These pensions typically are vested after quite a few years on the job and until recently were not portable.

Over the past several years a large number of the greatest corporations of the United States have had serious financial difficulties. Some have gone through bankruptcy and others have downsized dramatically. Firms have taken drastic steps to reduce not only their shop floor workers but also their overheads. The security of employment in the United states was never as great as in the Japanese system, but it certainly was much greater than it is today. The new situation means that the private pension and health care systems of the post war period are no longer viable. The Clinton administration is attacking the problems posed by the health care system; as yet there is no serious move to do better on the pension front.
The Clinton administration is a repudiation of the economics and the social policies of the Reagan-Bush years. They accept that there are government functions which are legacies of the past which need to be cut if not eliminated. There also is a recognition that programs like welfare, social security and health care require reformulation. A big issue as yet not addressed is how is the United States going to administer the industrial policy which up to now has been carried in the military budget?

The United States still has an unrivaled resource in the depth and wide distribution of research Universities: every state had on or more usually quite serious research university. Many of these State Universities have had strong applied research interests, usually in fields that are closely related to the State's economy. The harnessing of the power to create and innovate of such Universities and the transformation of the development arms of the defense department into a civilian advanced project agency are frontiers that the Clinton administration will have to address as they fully develop what they mean by industrial policy.

The end result will be a new model capitalism that takes the new model that was built in the 1930's and 40's as a taking off place. This policy will repudiate the old new model, which was the aim of Reagan. The new new model of capitalism will explicitly recognize that the achievement of
a full employment economy will have to come from organizations that fall outside the scope of the typical private corporation. Initially the corporation was a private organization chartered by a special act which was to carry out a public function. We can expect the new new model capitalism to contain corporations which mix private and public funding to carry out programs that have a social purpose. We can see glimpses of that in ideas that are floating for health maintenance organizations, for the development of technologies and for Community Development banking. It is not a matter of picking winners in some technological struggle but rather a matter of defining needs that can be filled with known techniques but which need special organizations to carry them out.

There may well be some experimentation in taxation. The progressive income tax was compromised by Reagan. The argument that income should not be taxed but that consumption is a fairer basis for taxation is gaining some following. Whether the courage to recognize that the logic of a consumption tax requires that the fair rental value of owner occupied housing needs to enter into the tax base for the calculation of the tax is in doubt. However a thorough and logical consumption based tax system will simultaneously reintroduce meaningful progression into the tax system and cut through the confusions relating to pension schemes which, as was mentioned earlier, is a dilemmas offered by
the American system of Social Security supplemented by tax supported private pension schemes.

The Clinton administration is in a uncertain way trying to discover the contours of a new model of capitalism: I don't think it is a conscious quest as yet. But as one item in the menu of unmet needs leads to another a new model which is more explicit in the partnership of public and private agencies in the development of resources than anything we have had in the States to date will emerge.