1. What attenuated the success of the early post war capitalism?

2. Why are the capitalist states now in crisis?

3. What are the contours of a new model capitalism?
FULL EMPLOYMENT AND RESOURCE CREATION RATHER THAN INFLATION CONTAINMENT AS THE OBJECTIVES OF ECONOMIC POLICY:

SOME THOUGHTS ON THE LIMITS OF CAPITALISM

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1. This is a quite broad reworking of a paper I presented in Milan Italy March 18th-20th 1993 at a Conference on "The Structure of Capitalism and the Firm in Contemporary Society".
   The call for that conference read:
   "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."
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March 4 was the 60th anniversary of the inauguration of Franklin D. Roosevelt as President of the United States. The climactic event of the great collapse of American Capitalism was the bank holiday that immediately followed the inauguration: officially the bank holiday began on March 6 1933. Our conference bridged the 60th anniversaries of the inauguration and the bank holiday. The combination of the dating and the topic of our conference made me think of the differences and the similarities between the scene as Roosevelt was inaugurated and as Clinton was starting his term.

In what follows I argue that the problems President Roosevelt faced sixty years ago and the problems that now confront President Clinton resonate. Each inherited a rich but failed economy. In the situation Roosevelt confronted the failure was so great that almost all did agree that something quite dreadful was wrong, although there was no
consensus on what the problem was, why it took place when it did and how to resolve the problem.\textsuperscript{2}

To date, in the 1980’s-90’s, the American economy and the rich capitalist world have dodged the bullet of a debt deflation, such as took place in 1929-33.\textsuperscript{3} But, using a concept attributed to Yogi Berra, the Fat Lady has yet to sing: we may be in the midst of a debt deflation that is being played out on a longer time scale.\textsuperscript{4} The wholesale

\begin{itemize}
  \item[2.] Roosevelt was inaugurated March 4, 1933. Hitler had taken power on January 20, 1933. Newspapers like the Hearst press (which supported Roosevelt in the campaign of 1932) found much to praise in Mussolini’s Fascism. Anti-laissez faire ideas, such as President Theodore Roosevelt’s New Nationalism, which looked to some form of State Capitalism as means of resolving problems of cyclical instability, insider manipulation of the financial system, growing importance of oligopoly, and the obvious inequality of income distribution, were very much "in the air". The Hoover Administration had put in place, although they did not do much with it, the Reconstruction Finance Corporation, a government investment bank, which was a key organization in the Franklin Roosevelt's variety of State Capitalism. Several government financing organizations that still exist, such as the Home Loan Banks and the Export Import Bank, were spun off from the RFC.
  \item[3.] Debt deflation is the label that Irving Fisher attached to the interactive process among debts, output prices, business cash flows, asset prices and employment which took place over 1929-1933 and other great depressions. See Irving Fisher, The Debt Deflation Theory of Great Depressions, \textit{Econometrica} 1, (October 1933), Also see Hyman P. Minsky, Debt Deflation Processes in Today’s Institutional Environment, \textit{Quarterly Review}, Banco Nazionale del Lavoro 143 (Dec. 1982).
  \item[4.] The National Bureau of Economic Research tells us that an expansion began in late 1992. As of this writing (late 1993) the data indicates that the expansion is "a sometimes thing": the expansion has been moderate, another dip is possible and the prospects for another set of crises in global financial markets are still alive.
\end{itemize}

Forty two months elapsed between the stock market crash in 1929 and the bank holiday of 1933. If the much larger share of government in GNP and the financial system interventions, by which governments prevent the negative net worth of banks, savings institutions and insurance companies
bankruptcies, massive asset price deflation and a collapse of GNP and large scale unemployment, which, if they occur, would create a consensus about the need for drastic government action, have not taken place as yet, and they may not. Whereas in 1933 the economic environment substituted for the gallows in concentrating the collective "mind", the amorphous fear that the current situation breeds has not concentrated the collective "mind".

S. Jay and David Levy, my colleagues at the Jerome Levy Economics Institute, diagnose the current situation as a Contained Depression. Such a depression does not send strong signals that something is seriously wrong with the economy. Because of the ambivalent nature of the signals that a Contained Depression sends President Clinton's call for change is not well focused: President Clinton and many in his administration know that something is wrong but they seem unable to put their finger on what is wrong.

passing through to the deposits and other non-equity liabilities, slow the debt deflation process then a debt deflation process in today's institutional environment may take much longer to fully develop than the 42 months between Oct 1929 and March 1933. If we take the stock market crash of late 1987 as a triggering event for a possible debt deflation, then the repercussions of this stock market crash may not be fully played out.

One aspect of the great depression was that the economy stagnated for many months after the downside movement was contained. The current performance of the rich capitalist economies resembles that of stagnant economies.

The government's of the rich economies are unwilling to use their spending to sustain a close approximation to full employment and to create resources which enhance the productive capacity of their economy. This inhibition to use their fiscal powers is due to a combination of an unwillingness to acknowledge that they are in fact rich and an unnatural fear of inflation.

One way in which the current era resonates with that of the 1930's in that the economies are not living up to the standards that were achieved in the recent past: furthermore rather simple minded policy interventions that were fairly successful are no longer effective. This attenuation of the effectiveness of policy interventions indicates that the institutional structure has evolved so that current economy is not a simple replication of recent economies.

An implication of the decline in the efficacy of policy interventions is that the institutional structure of the economy is not the same as it was in the past. Therefore to once again achieve a full employment - resource creation economy institutions need to be changed.

II. The New Model Capitalism of the 1930's.

Between 1933 and 1938, by a process of trial and error, the Roosevelt administration responded to the failure of the virtually laissez faire capitalism of the first third of the 20th century by creating an interventionist capitalism characterized by a thoroughly revised financial system, a
greatly expanded government, as well as increased regulation of labor and product markets. The reconstructed financial system aimed to constrain speculation and induce a focus on resource creation. Government spending raised the level of utilized to available labor and financed resource creation. The regulation of labor and industry aimed to improve the distribution of income and to contain private oligopoly power.6

The financial reforms of the 1930's reflected the view that the function of the financial structure was to abet enterprise, not to fuel speculation.7 Compartmentalization and transparency were the principles that guided financial reforms. Compartmentalization involved the creation of special financing agencies for different economic sectors (housing, rural electrification, agriculture and general business are some examples) as well as restricting the liabilities these different classes of institutions were permitted to issue. Transparency established the principle that information about the income and activities of publicly

6. In The New Dealers (Alfred A. Knopf, New York, 1993) Jordan A. Schwartz argues that the New Deal was largely an exercise in State Capitalism, in which the government partook in the the creation of financing vehicles for households and private business, the production of infrastructure and the emergence of innovative productions. In Schwartz's view much of the the governments role in resource creation and the funding of innovation was transferred to the military in the era of hot and cold wars. The current need to develop a post cold war institutional structure which facilitates resource creation and facilitates the adoption of innovative products and processes is one way in which the Clinton era resonates with the New Deal era.
held corporations and transactions on the exchanges of the equity and debt instruments of such companies were to be both truthful and widely available.

Transfer payment schemed were not the main thrust of the New Deal.\textsuperscript{7} The welfare state, which substituted transfer payments for income from work and owned property, is mainly developed after the 1960's, when the measured unemployment rate began its upward trend.

Direct government employment, offered by project related job programs such as WPA, NYA, and CCC, and large scale public works projects, which funded employment by contractors, were the main government income providing operations in the 1930's. Able bodied men and women, as well as youths, obtained income in exchange for work. It became a responsibility of government to provide opportunities for work when the private economy faltered.\textsuperscript{8}

Roosevelt inherited a failed and discredited capitalism. A new model capitalism, with an extended set of government interventions in the economy, was put in place. This did not take place in the first 100 days, during which the immediate problems of the acute crisis were tackled. The new model was mainly put in place in the second half of

\textsuperscript{7} Little in the way of entitlements existed; I don't even know if the word had been coined. Two premises, no one will starve in America and a dole is anathema, led to the "made work" programs of WPA, CCC and NYA.

\textsuperscript{8} In the early post world war 2 era the buoyancy of private investment demand and the sustained level of military spending combined with household demand for housing led to the achieving of a close approximation to full employment even as the ratio of government debt to GNP fell.
the first term and the first part of the second term (1935-1938). The new model, as augmented by the post war transfer payments of the "Welfare State", served the United States and the rest of the rich world, which adopted similar structures, well for almost half a century. 9

III. The Deteriorating Performance.

The performances of contemporary capitalisms have deteriorated, they have not broken down. Over the past dozen or so years the new model of 1933-1937 has developed ailments that is due to a combination of age and the infusion of laissez faire adulterants into the institutional structure during recent decades in which conservative ideologues administered the interventionist economy.

In the United States structural economic policy during the 1980's resurrected attributes of the capitalism that had failed in the late 20's and early 30's. An overhaul of capitalism is needed if the low levels of unemployment, the relative price stability, and the readily observed improvement in the standards of living that characterized the first 20 or so years after the Second World War are once again to characterize capitalist economies.

The prat falls and comedy acts of first four months of the Clinton administration make it seem far fetched to

9. The Social Security system was not a large pay out factor in the economy until the late 1960's and early 1970's when retired workers with 30 and 35 years of employment under social security became common.
propose that its historic task is to put in place a new new model capitalism which would develop programs and institutions which contribute to the creation of human, physical and knowledge resources and to the their full utilization (full employment). The Clinton administration needs to focus on policies to achieve full employment and to create resources. It needs to keep the programs simple: the New Deal work projects which were oriented to the achievement of concrete objectives are models for program initiatives.

IV. A Bit of History

The usual description of the 1933 bank holiday is "Roosevelt closed the banks." This is not true. By Saturday March 4 1933 the Governors of some 30 states had closed the banks in their states. Even as Roosevelt was being inaugurated he was informed that the New York banks would not open on Monday March 6. The bank holiday was a preemptive strike - it moved the resolution of the problem of illiquid and insolvent banks and other financial institutions from the financial community to the Federal Government.

The United States bank holiday was the climactic event of a great contraction of the American economy that began in October 1929 and lasted until March 1933 - some 42 months of well nigh monotonic decline. The decline was both long and deep. In the United States, and the United States was by no
means the worst case, 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 the winter of 1932/33 unemployment was at least 25% of the labor force: this in a country where 1/3 of the labor force was in agriculture.

Sixty years ago capitalism was a failed economic order. Today as the countries of the Soviet bloc, including the successor states to the Soviet Union, rush to become capitalist market economies, we must not allow the failure of Soviet communism to blind us to the weaknesses of capitalism. We need to examine:
1. What attenuated the success of the early post war capitalism?
2. Why are the capitalist states now in crisis?
3. What are the contours of a new new model capitalism?

The successful Capitalisms of the 1950's and 1960's were not the same as the failed Capitalisms of the 1930's. In general the 1930's system was a small government, gold standard constrained and essentially laissez faire capitalism. It was replaced by a big government, flexible

10. In the discussion of the Great Depression in the United States the focus is usually upon the unemployment rate and the fall in output prices. The fall in the indices of equity and of real estate prices was much greater than the fall in GDP or in output prices as measured by the CPI.

The Arthur Miller play *The Price* examines the effects through three generations of one family of the fall in the stock market. It is an excellent invocation of the emotional impact of the great depression on the previously well to do.
central bank and interventionist capitalism. As Mikal Kalecki and Jerome Levy pointed out, a government deficit is the equivalent of investment far maintaining the profits of enterprise. The big government capitalism that were put in place in response to the great collapse of 1929-33 protects the economy from a severe fall in aggregate profits, such as occurred in the great contraction of 1929-33. This makes the collapse of asset values, which was so critical to the great collapse, impossible.

The Roosevelt government used a variety of inadequately funded government employment devices to offset the weakness of the private demand for labor. Even though government deficit financing had a positive effect on profits in the middle 1930's, the scale was too small to lift profits to a high enough level to trigger a resumption of private investment. Not until massive government contracts for defense production in the late 1930's was government spending sufficient to set off the flows of funds that lead to a recovery of private investment.

Full expansion from the great depression depended upon the recovery of private investment which required a new financial structure, learning how that financial structure operated and borrowers and lenders regaining confidence. Financial reform was an integral part of the new model capitalism that was set in place in the 1930's
As households, firms, government units as well as financial institutions learn how a new financial system works they modify their behavior so that they can best profit within this new financial structure. In fifty years such changes have led firms to use more debt relative to internal finance and new equity issues for investment financing, even as financial market changes facilitated the greater use of debt to hold positions in existing assets. As a result a once robust financial system became increasingly fragile, which implied that the likelihood that a small stimuli will lead to large changes increased. A fragile financial structure leads to an economy that is unstable.

There was no threat of a financial crisis between the end of world war II and 1968. In 1968 the repercussions of the commercial paper market to the default of the Penn Central Railroad on its commercial paper, rudely awakened the rather complacent Federal Reserve Board of Governors that it has responsibilities for maintaining the stability of the financial system. Since 1968 the Federal Reserve has often been forced to take steps to abort what it deems to be an embryonic financial crisis that arose from a lack of liquidity in some set of institutions or markets.

The big government capitalism of the 1950's and 60's succeeded in moderating business cycles because the big governments were able to sustain business profits when investment lagged. One significant result of the short and
V. Reconstituting the Financial Structure in the Thirties.

During the Roosevelt years the reconstitution of the financial structure was a major policy task. It involved a great deal of position taking and negotiation. It was not until after 1936 that the new financial structure was in place. The 1936 financial structure of the United States was based upon two principles, compartmentalization and transparency. The financial structure was reconstituted with special financial organizations for specified functions i.e. for housing, for agriculture, for imports and exports, for commercial banking, for investment banking and for deposit insurance.

A government investment bank, the Reconstruction Finance Corporation, was part of the control and support mechanism for the financial structure and for the financing of resource creation: it operated by infusing government equity into transportation, industry and finance.\footnote{11}

11. The immediate resolution of the banking crisis of 1933 was led by the Reconstruction Finance Corporation, which took equity positions in about 50% of the banks that reopened after the bank holiday. The Federal Reserve which had been created in an effort to control systemic bank failures by supplying liquidity failed on stem systemic bank failures in the 1930's when the problem was caused by the erosion of equity due to non-performing assets.

In the savings and commercial bank crisis of the 1980's the Federal Reserve once again was unable to contain the failures and assure the validation of deposit liabilities: the Treasury supplied the funds to validate deposits and to constrain the forced sale of assets. The Federal Reserve is not capable of containing a solvency crisis. It seems as if a government investment bank / holding company is necessary if adverse system wide consequences of an epidemic of non-performing assets are to be contained.
The operations of the publicly traded corporations and the markets in which the trading took place were to be transparent. In addition the Federal Reserve was reorganized so that the gold standard rules of central bank behavior no longer forced the Federal Reserve to be deflationary when prices were drastically dropping and unemployment was high.

The financial institutions of the post 1936 era differed markedly from that which broke down between 1929 and 1933. Once in place this system evolved as a consequence of the profit seeking efforts of the various institutions. Any institutional structure which sets limits to the self seeking behavior of economic units will set off reactions designed to evade or avoid the limits. In addition technological changes impinge upon the profit potential of units in the financial structure in a variety of ways. As a result of institutional and usage responses to constraints and technological changes, the effect upon the operations of an economy of a legislated and administered institutional regime will change. Even though the formal Roosevelt financial structure has largely remained in place since the 1930's, the operating details of the structure as well as the consequences of the structure for the financing of "the capital development of the economy", the portfolios of households and the stability of the economy have changed.
shallow recessions that characterized this era was that the market power of unions was strengthened. The combination of strong trade unions, a lack of sustained unemployment and social legislation led to the lot of those at the "bottom" of the income distribution improving. It also led to inflationary pressures due to the combination of higher unit labor costs due to the market power of unions and the way in which the strength of the economy sustained the market power of firms.

President Kennedy caught the flavor of the experience of the first two decades after World War II in the aphorism "A rising tide lifts all bottoms." This aphorism has been negated by the experience of 1980's, when the lot of those at the bottom stagnated or deteriorated even though aggregate income measures indicated continued improvement. It seems clear that Capitalisms can function in a variety of different ways and that preference systems and the technical conditions of production do not lead to a "law of distribution".

If capitalisms are to be successful in the 21st century they are likely to be quite different from the models we are familiar with. Now that Roosevelt's new model of Capitalism has shown that Kennedy's aphorism can be true, the ends that a successful economy needs to achieve includes a wider distribution of the fruits of prosperity than was achieved over extended periods of time by the pre 1930's model capitalism.
VI. Why are the Capitalist Economies Now in Crisis?

Reagan and Thatcher tried to overthrow the big government interventionist capitalisms that they inherited. In the United States the major substantive changes in the economy of the Reagan years were

1) the destruction of the revenue system,
2) the emergence of an economy that was structurally dependent upon the government's deficit financing of a budget that was mainly devoted to military spending,
3) the support of consumption by way of entitlements,
4) the fall in the real wage of a large portion of the labor force and
5) a rising tide of unemployment.

After a spurious prosperity, largely based upon

1) an unproductive government deficit,
2) an enormous expansion of the financial services industry and
3) Ponzi financing schemes, that left the country with an excess supply of office structures, highly indebted firms and non-performing assets. The Reagan-Bush years saw the price economy of the United States virtually stagnate. Furthermore government spending was even more inefficient as an instrument to create resources than it had been earlier, because the great expansion of the government debt and the high interest rates, that were a long lasting legacy of the
experiment in practical monetarism of the Volcker era, left a huge item "interest on the debt" in the budget.

The Reagan-Thatcher-Bush experience, which is a second failure of the laissez faire model showed that the laissez faire model of capitalism cannot meet the performance standards established in the 1950's and 1960's. Clinton in his still new administration is groping towards the invention of a "new" new capitalism. This "new" new model accepts the central tenet of Rooseveltian capitalism, which is that effective capitalism requires a large government sector, but it shifts government spending from financing defense and consumption to financing resource creation and the efficient delivery of those services for which fee for services mechanisms for the rationing of access and the recovery of costs are either not effective or carry unacceptable social costs.

VII Essential flaws of Capitalism.

I have not addressed the questions of what are the flaws that made capitalism a failure in 1933 and whether these flaws are the result of attributes of capitalism which are essential characteristics of capitalism. 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. The abysmal low standards of life that are now associated with even
relatively successful capitalisms are largely side effects of the inability to maintain such approximations to full employment.

Keynes imputed this to the fact that capitalism is not merely a market economy: it is also a financial system. A fundamental aspect of capitalism is that there are two sets of prices. One set consists of the prices of current output. The second 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.¹²

Current output prices carry profits and are the mechanism by which costs are recovered. In the abstract these prices are keyed to the money wage rate. The price of capital assets and financial instruments are present prices for future streams of incomes. These two sets of prices reflect what happens in different sets of markets: in particular their proximate determinants are different. As a result they are capable of and they do vary one with respect to the other. Capital asset and current output prices cannot be constrained to form a constant ratio.

The financial instruments issued by firms are held by households and financial institutions such as banks.¹³ Ever

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13. In a modern economy household and government debts exist and are held by financial institutions and directly by households. These other liabilities both complicate the cash flows and offer routes which can either dampen and
since the corporation became the dominant form of business organization, the liabilities of firms include equity shares as well as various forms of debts. The equity shares and some of the debts of some companies are freely traded on public markets: the market value of these instruments depends upon publicly available information. In principle the second price level of capitalist economies is an index of the market price of existing capital assets, but in practice it is an index of the market price of shares and debts.

The growth of the holding company form of corporate capitalism means that entire lines of business are sold and bought. The model of the second price level needs to incorporate how such components of firms are valued.

The reforms of the financial system during the Roosevelt era made transparency the over riding principle for corporate management and the operation of markets where financial instruments are issued and traded. Information about the operations of corporations and of markets on which equity shares are traded was to be freely available.\(^{14}\)

amplify the effect of the business and financial debt structure on the performance of the economy.

In particular whereas in a clean no household debts, no government debts economy interest income is always a distribution of gross capital income in our dirty in fact economy interest income is not only a distribution of wage incomes it is also a claim on tax incomes.

14. This freely available information means nothing unless there sophisticated and knowledgeable analysts of this data An effective transparent financial system requires security analysts, who distribute their analysis usually for a fee or in exchange for the use of their "firms" services. The lack of assurance about the integrity of security analysts may be
Other liabilities of corporations - debts to banks and private placements - do not depend upon publicly available information but rather on negotiation and discovery. Such debts, which are not marketable, can be syndicated among institutions, such as banks, insurance companies and pension funds, which are deemed to be knowledgeable about processing private information.

As a result of the security market reforms of the Roosevelt era the law caught up with the fact that modern capitalism is corporate capitalism.

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 such as office towers. If the ratio of the prices of old and new capital assets was greater than 1 to 1 before 1929, in 1933 the ratio of old to new was 1 to 4. 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 an explanation of the rise of the open ended mutual fund as the proximate supplier of equity and debt assets for households.
prices. However to producers in a capitalist economy output prices recapture wage and material costs and carry profits (gross capital income). These profits enable a firm to pay the interest and principle that is due on debts, and to 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 prices reflect present views about future money flows. The market value of a firm is a capitalization of its nominal profits and therefor it is stated in nominal terms.

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 sale 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.

15. Retained earnings are the way the equity base of a corporation grows without recourse to the sale of equity on the public market.
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 current 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.

In practice in a modern rich capitalist economy corporations are 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, mutual funds and pension funds to identify the most prominent financial intermediaries — are self seeking (profit seeking) institutions. In a modern capitalist economy maximizing behavior is not restricted to
households and firms that own capital assets: the entire array of financial intermediaries seeks profits. Each profit seeking financial intermediary has its own agenda: 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 who 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 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 therefor 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 expected to be 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 value of the 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 1) the capitalist technique of valuing outputs and valuing capital assets, 2) the market determination of liability structures and 3) the possibility of sharp increases and decreases in the market price of capital assets and financial instruments lead to system determined increases and deceases in the price of assets relative to the price level of current output. This ratio feeds into the amount of investment financed, which in turn leads to the flow of current profits.16

Once current profits fall by enough, or the carrying costs of debts increases by enough, so that the cash flows earned by operations or from financial assets by 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

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16. The relation between the price level of capital assets and current output along with other factors determines the volume of aggregate demand and the excess or deficient demand for labor at the current wage rates. This excess or deficient demand will affect the movement of wages and thus the price level of investment output.
out positions. The result can be a sharp fall in asset values. A downward spiral is a possibility in which investment ceases and profits evaporate: the end result of over indebtedness can be a great or a serious depression.

Although the obvious flaw in capitalism centers around its inability to maintain a close approximation to full employment, its deeper flaw centers around the way the financial system affects the prices and demands of outputs and assets, so that from time to time debts and debt servicing rise relative to incomes so that conditions conducive to financial crises are endogenously generated. Such a crisis, if not contained by a combination of Central Bank lender of last resort interventions, which sustain asset prices, and government deficits, which sustain profits, leads first to a collapse of investment and then to a long lasting depression accompanied by mass unemployment.17

This financial flaw cannot be eradicated from the corporate form of market capitalism, in which liabilities exist that are prior commitments of the gross nominal profit flows of corporations. Reforms which constrain the possibility of using excessive debts for specified purposes were part of the new model capitalism of the 1930's. Many aspects of these constraints were relaxed by the 1980's, especially critical constraints upon the assets eligible for the portfolios of the Savings and Loan Associations were

17. In this view the intervention by a deposit insurance authority to assure that deposits at "protected institutions" are paid at par is a central banking action.
relaxed. The result was a series of crises of financial institutions and corporate indebtedness. A big depression did not happen in the early 1990's because the government validated the debts of the financial institutions that became insolvent and the huge government deficits sustained profits.18

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 in which the new interventionist model worked well 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

18. This validation has been called a bailout.
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 therefore to a sharp fall in the value of capital assets as collected in firms remained.

VII. Some more History

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 of the early 1990's ultimately led to a sharp fall in first short term interest rates that, with a lag, is being followed by a fall in longer term interest rates. This fall in interest rates led to a rise in the present values of income streams: Asset values increased and as a result the turbulence in financial markets in the United States has abated.

The capitalism that failed over 1929-33 was a small government constrained Central Bank essentially laissez

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faire economy. The capitalism that had a good run after the second World War was a big government interventionist 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 plus 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 some details of 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 plus 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 those which 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.
VIII Dimensions of the Crisis in Policy

"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, which is the keystone of the welfare state in the United States, was never adjusted for the enormous increase in life expectancy over the past sixty years. 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 would increase the labor force. Therefore there is a need to increase the number of available jobs.

Another problem of the welfare state in the United States is with what is called welfare in the United States. This system, Aid to Families with Dependent Children (AFDC), provides cash and in kind (medical care, housing and food subsidies) support to families with children, if income from work or assets is not available to support the children. In practice significant part of the population that is welfare dependent is seemingly locked into a pattern of dependency: women who were raised by recipients of AFDC having children who in turn are being raised by a woman on AFDC. This welfare problem is increasingly viewed as a disaster in terms of the well being of the recipients. However the
alternative to welfare is work for the mother and child care for the children.

Welfare reform leads to a similar problem as social security reform. Having people now on welfare or on Social Security enter the labor force increases the demand for jobs. The problems of the welfare state in the United States stem from the inability to achieve and sustain a tight full employment without triggering inflation.

We now live in a world where less than 3% of the United States' labor force is in agriculture and where a decreasing percentage of workers can produce all of the standard manufactured goods that the economy demands. There is a need to support more workers in the production of socially useful outputs that are not manufactured goods and where the costs may not be recoverable by any simple fee for services arrangement. In the United States military spending, on both weapons and manpower, supported workers whose costs were not covered by a fee for services arrangement: taxes and government borrowing raised the funds for such these expenditures. There is a need to replace the military use of available resources with other forms of resource use which do not depend upon fees for services for funding.

There is one crisis in America's welfare state 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: workers were tied to corporations which presumably had secure market positions in perpetuity.

Over the past several years a large number of the great 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 in the past than it is today.

The newly revealed vulnerability of corporations 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 of our health care system. As yet there is no serious attack on the problems of the pension system that supplements Social Security.

The Clinton administration is a repudiation of the economics and the social policies of the Reagan-Bush years. It accepts that there are government functions which are legacies of the past which need to be cut if not eliminated. It denies the conservative assertion about the incompetence of government. The administration also recognizes 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 has one or more usually quite serious establishment. Many of these State Universities have strong applied research interests, usually in fields that are closely related to the State's economy. The harnessing of the power to create and invent 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 of the Clinton administration is likely to be a new new model capitalism that uses the model put in place in the 1930's and 40's as its point of departure. This new new model will not repudiate nor attempt to dismantle 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 are neither typical private corporations nor government departments as we have understood them in the United States.
Initially the corporation was a private organization chartered by a special act to carry out a public function. We can expect the new new model capitalism to create corporations which mix private and public funding to carry out programs that have social purposes. We can see glimpses of this 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 require special organizations to carry them out.

There may well be some experimentation in taxation. The progressive income tax was compromised by Reagan.20 The argument that consumption is a fairer basis for taxation than income is gaining some following. It is doubtful whether the political courage exists to recognize that the logic of a consumption tax requires that the fair rental value of owner occupied housing enter into the consumption measure used for calculating the tax. However a thorough and logical consumption based tax system would simultaneously reintroduce meaningful progression into the tax system and cut through the confusions relating to pension schemes.

20. The 1993 tax act improved the fiscal picture but it did not undo all of the harm of the 1980's to the revenue system of the United States.
As was mentioned earlier, pensions are a policy problem due to the American system of a government Social Security System supplemented by private pension schemes, which are publicly supported by the exemption of income placed in pension funds from taxation either at the corporate level or at the beneficiary level.\textsuperscript{21} Furthermore the income earned by assets held by pension funds, as well as the portfolio gains are exempt from taxes until beneficiary begins to receive pensions from the fund.

IX. Conclusion

In a tentative way the Clinton administration is trying to discover the contours of a new new model of capitalism: as yet it is not a conscious quest. But as one item in the menu of unmet needs leads to yet another and as the Administration seeks to define "the better" the country deserves a new new model of Capitalism will emerge which has as an anchor a partnership of public and private agencies in the development of resources. This new new model will be based upon a more explicit recognition than anything that has hitherto guided policy in the United that the capitalist market technique of creating resources is flawed in that it is inherently myopic and it needs to be permanently ---

\textsuperscript{21} Whereas placements into pension accounts are to a limit (which is a substantial part of income for almost all) pre tax dollars employees "contributions" to Social Security are of after tax dollars. Symmetry would call for making the "contributions" of employees to Social Security pre tax dollars. Once this is done the reason for exempting social security payouts from taxation vanishes.
supplemented by the long view that government alone can have.