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The Failure of Official Economics

by

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Our current economic situation of inflationary recession and amplified instability is grist for the view that our official economics has failed. Official economics is the economic theory that guides the analysis and recommendations of the economists who serve our presidents and legislators. Economists guided by this view of the world serve on the The Board of Governors of the Federal Reserve System and in the Cabinet. They brief reporters and commentators.[1]

Official economics has failed on three fronts: the economy is not working well, policy is ineffective and the official theory as theory is full of logical holes. Official theory is bad theory and bad theory leads to ineffective and counter-productive policy.

This official economics theory comes in two brands--old-fashioned monetarism and conventional Keynesianism. Economic policy that follows prescriptions derived from monetarism, conventional Keynesianism or any "linear combination" of the two won't do for American capitalism because the instability so evident in the past fifteen years is foreign to the theory. The "policy" and the "business" problem is to do well in an economy that is unstable because of its internal or inside characteristics. Official theory either does not explain instability or assumes instability is due to phenomena that are external or outside to the economy. Official theory therefore fails as a guide for policy because the critical problem of instability that policy must deal with is foreign to the theory. As I concluded in a recent piece in Challenge our performance has been poor because "nobody up there (in the

policy establishment) understands American Capitalism."[2] If we are to do better in the fifth fifth of the 20th century than we did in the fourth fifth policy has to be guided by an understanding of how American capitalism is flawed and what can be done to ameliorate the consequences of the flaws.

What is American capitalism? It is a capitalist economy which uses massive and often special purpose capital-assets in production and which has a very sophisticated and complex financial structure by which ownership and control of capital-assets is affected. The basic producing unit of the economy is the corporation. Producing corporations are financial organizations which "own" and "operate" capital assets and which finance this ownership and operation by a more or less complex liability structure. Corporate as well as household and government liabilities are largely held by financial corporations (banks, insurance companies, pension companies, etc.). The assets owned by households directly and indirectly finance the ownership of corporate capital-assets; the deposit in your checking account is a type of bond that finances the collection of assets owned by the bank in which your deposit is now momentarily at rest.

It is impossible to explain the behavior of the American capitalist economy by separating money and finance from the production of outputs, the allocation of resources, and the distribution of income. Official economics in fact does separate the two sets of markets; this structure of official economics fundamentally misspecifies the interactions in our economy.

Standard economic theory starts by analyzing an artificial barter economy. It derives theorems for this abstraction and then attempts to show that these theorems carry over as the extreme assumptions of the initial set-up are relaxed. It has never been shown that the propositions carry over to an economy with capital-assets and monetary and financial institutions such as

we have. From the way the official theory is set up it is impossible to derive propositions to the effect that our economy is unstable because the financial and relative price relations which lead to instability nowhere appear in the models of the official economists.

However instability exists. The official theory explains instability as the result of outside shocks upon the economy. Stabilization policy based upon the neo-classical synthesis looks to stabilizing money as an "outside factor" whereas to a capitalist investing economy money is an inside factor.

Given the accumulated debt structures of business, the compromised equity positions of many financial organizations, the legacy of inflation and unemployment and the chronic trade deficit, American capitalism will be under stress in the 1980's. This will be a very exciting time for economists as scientists. If economics as a scientific discipline rejects the blinders proferred by official economists a great deal should be learned about how a capitalist economy works. It can be the most exciting era in economics as a science since the 1930's because once again economic theory has to be reconstructed and changed.

On the other hand, the 1980's are going to be a tough period for those who have to live and work through these years. The instability so evident in the 1970's will persist. There will be serious and profound institutional changes which will either evolve as business and policy makers put out fires and react to crises or result from a legislative reaction to the crises. If policy is guided by a vision as to what really makes our type of economy run and we have serious and forceful leadership the 1980's, this legislation can ecnompass much needed constructive reform. If current official theory guides policy much longer I fear we will slide into a quite undesirable Schachtian solution: controls, government participation in refinancing, planning by tripartite (government, labor and management) committee to protect

established centers of private market power, and bilateral international trading relations are some dimensions of a Schachtian reaction to heightened cyclical instability. Chrysler, Lockheed, First of Pennsylvania and the bail-out of the Hunts and Bache and Company are examples of refinancing interventions. Future steps in a Schachtian drift will be labeled programs of reindustrialization and international coprosperity spheres.

Unless positive steps are taken based upon a deeper analysis of our economy than the neo-classical synthesis the last part of the 20th century will see a much attenuated enterprise system. Enterprises will be dependent upon government protection, institutionalized market power and funding. The mechanisms will be industrial self government (a forced cartelization of industry) and periodic infusions of government funds to steer and support industry.

The years since the end of World War II separate into two parts. The first, from the end of the war to the mid-60's, was a tranquil era. It was characterized by economic progress on many fronts. Fundamental price stability and low unemployment rates ruled. It was a calm interlude of progress in a normally very cyclical economy. These 20 or so good years are an aberration. The norm is the turbulence of the past 15 years.

The first 20 years after World War II are a golden age of American capitalism. During these years the economy delivered multi-dimensional and serious improvements to broad segments of the population. This golden age of improvement also happened in the other capitalist countries. In the United States it was mainly a legacy of the Roosevelt reforms.

In the 1960's the reformed Roosevelt capitalism began to falter. Since the middle 60's the economy has been characterized by increasing turbulence. We've had a succession of aborted financial crises which required intervention by the central bank to protect the financial structure . We've

had a rising trend of inflation and unemployment through the cycles of the 1970's.

The normal behavior of the economy has given us a history of monetary turbulence and experiments. The monetary experimentation started with Alexander Hamilton and the assumption by the Federal Government of the debts of the states so as to build that great good thing, the national debt. Hamilton, the Smithian "conservative," believed that a national debt was needed to give the country cohesion and unity through a national monetary system. It is not necessary to repeat the tales about Jackson, the Second Bank of the United States and the great depression of 1837 that followed the demise of the Second Bank. The era of wildcat banking which followed in the 1840's and 50's saw strong economic growth associated with a "chaotic" banking system that after working well enough for almost two decades "broke down" in a crash in 1857.

The monetary reforms of the National Banking Act of 1863 were supposed to bring order out of chaos and eliminate crises (i.e., the business cycle). The years following the Civil War saw monetary crises and business depressions in each decade, culminating in the crisis of 1907 that put reform of banking on the national agenda: William Jennings Bryan's "cross of gold" speech reflects the mood of monetary and economic disarray in the decades following the Civil War. Following the crash of '07 a Central Bank was created to bring stability by bringing flexibility to the "note issue" by means of a Federal Reserve. The Federal Reserve was supposed to usher in a new era of stable growth;it was supposed to bring order out of chaos and eliminate crises (i.e., business cycle). The stock market boom, crash and the collapse of the financial system between 1929 and 1933 showed that the Federal Reserve was not enough to bring stability.[3]

The New Deal saw a revision of the Federal Reserve and a spate of financial regulatory and insurance devices. After the Second World War, the

belief once again was that the reform of financial institutions together with fiscal policy had once and for all eliminated the possiblity of financial instability and deep depressions. Beginning in the mid-1960's this belief was contradicted by the evidence; however since the middle-1960's instead of instability leading to deep depressions it has led to a trendwise accelerating inflation coupled to trendwise rising unemployment.

The lesson to be drawn from history is that finance doesn't manage itself. If a society is going to have a successful capitalist society that delivers prosperity then financial practices have to be controlled. The Federal Reserve System is the key element in the government's attempt to control the financial system. In the recent past a great deal has been written about the Federal Reserve as the controller of the money supply. Furthermore it has been asserted that an appropriate control over the money supply assures that all sorts of nice things happen.

The Federal Reserve does not control the money supply. The money supply is determined by practices in the financial system. Anybody can create money. The problem is to get your liability accepted as money. The structure or composition of bank liabilities over the 35 years since the end of World War II, shows a continuing evolution of practices and usages. This evolution reflects ae property of money in a capitalist economy. Money is a way of financing transaction. A fundamental error of our official economic theory is that money is treated as something exogenous. In the econometric models so beloved of official economists, the vision of how money changes is often that of a helicopter flying over a city spilling out greenbacks; money rains take place to change the quantity of money.

The Federal Reserve System is a lender of last resort. It was created to assure that financing available through banks and money markets would not

collapse. It was also created to assure that the supply of finance would be able to accomodate a growing demand for financing.

Allowing supply to grow with demand is dangerous, for the demand for finance is a function of prices and outputs. A responsive or accomodating financial system can be an engine of inflation. The "art" of central banking is to allow the financial system to accomodate but not to accomodate too much.

The Federal Reserve as the lender of last resort assures that refinancing will always be available for key organizations (banks) which hold designated eligible assets. By so protecting banks the Federal Reserve presumably assures that a local difficulty will not become a generalized financial crisis. The banking system issues protected classes of liabilities, demand and time deposits. The Federal Reserve as the lender of last resort is not supposed to protect the net worth of any particular individual or any particular enterprise. The theory of central banking suggests the liabilities of institutions other than banks are to be liabilities at hazard. Central banking theory recognized that once all liabilities of banks and non-banks are protected the prudent banker constraint on the financing of activity vanishes. Whereas insurance to protect demand and passbook savings deposits to some modest limit is a legitimate use of Federal Reserve lender of last resort interventions, the protection of the net worths of the Hunts, Bache, and particular commercial banks is not legitimate.

A lender of last resort is needed because there are weak points to any financial structure. The theory of the official economists, whether they are called Keynesian or monetarist, holds that a change in the money supply leads to a change in prices and employment in the same direction. The theory that underlies policy is that the rate of change in the

money supply controls the rate of change of prices and employment.

Our economy with its elaborate financial structure doesn't work this way. Money is created in transactions between bankers and customers. These transactions finance some activity or transfer assets to banks. When banks acquire assets the financing through banks increases, which can lower nominal interest rates and change relative asset values. With variations in the interest rates, the cash flows of businesses which are required to validate the debt structure increase or decrease relative to the cash flows on the debtor's assets.

All business men know about cash flows. Economists were late to discover their significance because the official economic theory has no place for captial assets and liability structures. Every business has financing and refinancing problems. When the Federal Reserve engages in monetary constraint, refinancing problems can become acute. Organizations are pushed to the brink as bankers, looking at cash flows and the market values of assets, refuse credit even as there is an urgent need for cash by the prospective borrower because debts are falling due. The proceeds from the prospective loan were to pay debts that were entered upon earlier. A refinancing crisis can be as spectacular as that of the Hunts or as modest as a small speculative builder who fails because take out financing is too expensive or even unavailable to home buyers.

Monetary policy to constrain inflation sets up a race between the effects of the decrease in financing upon prices and employment and the effects upon interest rates, asset values and the viability of financial postures. The theory of monetary policy of official economists ignores the effects of monetary constraint upon the viability of financial structures. Scenarios in which policy gradually squeezes out inflation with little unemployment over many years are advanced by official economists. But our system never works that way.

Regardless of the printouts that come from econometric models, the American economoy doesn't move through time smoothly. It lurches, because monetary and fiscal constraint trigger a race between the deceleration of inflation and a financial crisis. Ever since 1965 the financial crisis has won the race. A policy of constraint pushes financial organizations and markets over the brink so that a process is started that would lead to a classical debt deflation, deep depression if it is not constrained. Anti-inflationary monetary policy is like chemotherapy in the treatment of cancer where enough poison is put in the system to virtually kill the patient. The progress in cancer treatment is for the cancer cells to be killed and not the patient. It's a peculiar analogy, but the standard anti-inflationary monetary policy is based upon the hope that inflation can be stopped before the economy is too far on the road to disaster. This has been tried four times between 1915 and 1979. In the three cases that are now history--1966, 1969, and 1974--the deep depression was successfully avoided but the relief from inflation was of short duration. The fourth case had its crunch in the spring of '80 and the jury is still out on whether inflation has been affected.

Since 1965, we have had four brink episodes. One was the credit crunch of 1966. The Federal Reserve intervened in September of '66. Everytime the Federal Reserve intervenes during a crunch it protects and validates financial practices which were in part responsible for the prior inflation. After 1966 they validated the negotiable certificate of deposit by giant banks and the use of corporate cash to finance banking. These changes began the move by banks away from depending on demand and pass book time deposits. The change to liability management banking, which is a banking structure that is much more independent of central bank controls, was facilitated by the Federal Reserve action.

In 1969-70 there was a commercial paper market, Chrysler crises. Chairman Arthur Burns led the Federal Reserve intervention to make sure that

the commercial paper market was sustained and Chrysler was refinanced. In this process the Federal Reserve validated the commercial paper market. In 1974/75 the Franklin National, other large bank and REIT episode took place. In that episode the Federal Reserve validated the Eurodollar market and the use of commercial bank concessionary financing to refinance and carry walking bankrupts. The Federal Reserve, the Controller of the Currency and the other regulatory authorities shut their eyes to banks' holding of assets that had little or questionable value. These questionable assets were made good by the inflation of 1976-79.

We now have the fourth brink episode: the Hunt-Bache breakdown, occurring just as Chrysler and the First of Pennsylvania were going over the brink. This time the Federal Reserve validated brokerage house intermediation and seemingly established the precedent that if you are big enough the Federal Reserve or the Treasury will see to it that you won't fail.

Thus since 1965 there have been four episodes that could have triggered a big depression. There are two reasons why we haven't had a big depression in these years. One is that the Federal Reserve has promptly intervened as a lender-of-last-resort when a financial crisis threatened. This intervention means that an immediate, direct or indirect, infusion of reserves into banks takes place. The Federal Reserve radically relaxes monetary constraints. Furthermore the validation by the Federal Reserve of new financial practices effectively leads to a large increase in the liquid asset base and the financing capabilities of the economy. The second reason is that our big government, with its enormous transfer payment system, has a huge deficit whenever income turns down. The government deficit is a good thing primarily for business aggregate after tax profits. Business gross profits equals investment plus the deficit. The gross profit flow to business is what validates the liabilities of business. When investment fell between '29 and '33 gross corporate profits fell enormously. In 1974-5 we had a substantial [illegible] [illegible] dramatic a fall in investment as in 1929-33. There was an

enormous increase in the deficit in 1974-5 whereas the budget deficit barely increased in 1930. The increased deficit in 1975 led to a rise in gross after tax corporate profits in 1975 in spite of a 20 percent decline in industrial production. When the second quarter of '75 is compared to the second quarter of '74 unemployment was over the 9 percent rate from 6 percent a year earlier and industrial production was down about 20 percent; even so corporate gross profits were 40 percent higher than the year before.

Profits equal investment plus the deficit. This fundamental equation for a capitalist economy tells us that a government deficit is mainly good for profits. Big governments and its deficits are a curse when they lead to inflation and a blessing when they prevent a deep depression. But the combination of the Federal Reserve as a radical lender of last resort in a crisis and a massive government deficit, which increases the government debt outstanding and allows banks to shift their portfolio to store up financing for the future, makes it certain that several years (four or five at most) after a 'crisis' inflation and interest rates will be higher than that which brought about the crisis.

In 1974-5 I was arguing that everything the Ford administration was doing to "halt the recession" was making it certain that we would have greater inflation in four or five years. This message went unheard. Mr. Ford and Mr. Burns are more responsible for the inflation of 1979 than Mr. Carter and Mr. Volcker or Miller.

Our economy is now trapped in a dismal cycle. Expansion is unstable for it goes over to inflation with speculative excesses. This leads to monetary constraint and explosive interest rates. A break in the financial structure, such as the failure of Franklin National Bank or the collapse of the silver bubble which left the Hunts and Bache high and dry, follows. Lender-of-last-resort interventions by the Federal Reserve and cooperating

institutions prevent the break from triggering a full-fledged collapse. In addition a massive government debt sustains and increases profits. Thus after a sharp break in income, a recovery begins and we are back to the unstable expansion.

In the current cycle the financial market break came in March when First of Pennsylvania, Chrysler and the Hunt/Bache speculations were "refinanced" on concessionary terms; a covey of covert bankruptcies substituted for overt bankruptcies. The special phenomena of early 1980 was the collapse of the Hunt position in silver. In the view of the analysis of how finance interacts with the economy, the Hunt/Bache affair was a bankruptcy that should have been allowed to run its full course without Federal Reserve intervention and protection. The equity position of the Hunts and Bache could have been allowed to go to zero and the equity of the banks that financed the Hunts and Bache should have borne losses. Federal Reserve intervention was called for only after the equity position of the banks that financed the Hunts and Bache was compromised. As a result of the way the financing trauma of 1980 was handled by Volker's Federal Reserve and the massive deficits in prospect for 1980/81, the inflation and interest rate of 1979 will be back, most likely at a higher level, by 1984.

There is one contingency that will stand in the way of such a recapitulation of 1975/79 in 1980/84. In 1975, the last time we were at the current stage in the dismal cycle, Japan and the European economies had just been hurt very badly by the rise in oil prices. The dollar was strong, a safe haven for the accumulations of the newly rich OPEC countries. The turnaround of the economy did not trigger a flight from the dollar. This time a turnaround of the economy with the prospect of accelerating inflation and alpine interest rates may soon be followed by a flight from the dollar, which will put severe strains on the international banking system. It

is such an international crisis that is likely to usher in a Schachtian solution.

Is there a way out? I don't think there is at present because policy makers, politicians and the public fail to understand the peculiar nature of American capitalism. It is a very vulnerable system. It always has been. We have to understand why it delivered for 20 years with a robust financial structure and then stopped progressing when the financial structure became fragile. Capitalism needs the oversight, protection and control of a state administration that recognizes its flaws. The public, various administrations and the Congress have not been well served by their economists because these economists have not made the fundamental limitation of our type of economy clear. The first step toward doing better is to understand how the capitalism we have is flawed.

FOOTNOTES

[1]Official economics is the theory that was formalized in D. Patinkin, Money, Interest and Prices, 1st ed., Branston, Ill., Row Peterson, 1956. It has roots in J.R. Hicks' "Mr. Keynes and the Classics," Econometrica (V), 1937, and A. Hansen, Business Cycles and National Income, New York, W.W. Norton, 1951. Although this theory--the neo-classical systhesis--claims to have roots in J.M. Keynes' The General Theory of Employment, Interest and Money, New York, Harcourt, Brace, 1936, it really owes more to J. Viner, "Mr. Keynes vs. the Causes of Unemployment," Quarterly Journal of Economics (51), 1936.

Monetarism is a variant of this theory. It received an early statement in M. Friedman, ed., Studies in the Quantity Theory of Money, Chicago, University of Chicago Press, 1956.

[2]H.P. Minsky, "The Federal Reserve: Between a Rock and a Hard Place," Challenge, Vol. 23, #2.

[3]C.P. Kindleberger, Manics, Panics and Crashes, New York, Basic Books, 1978.