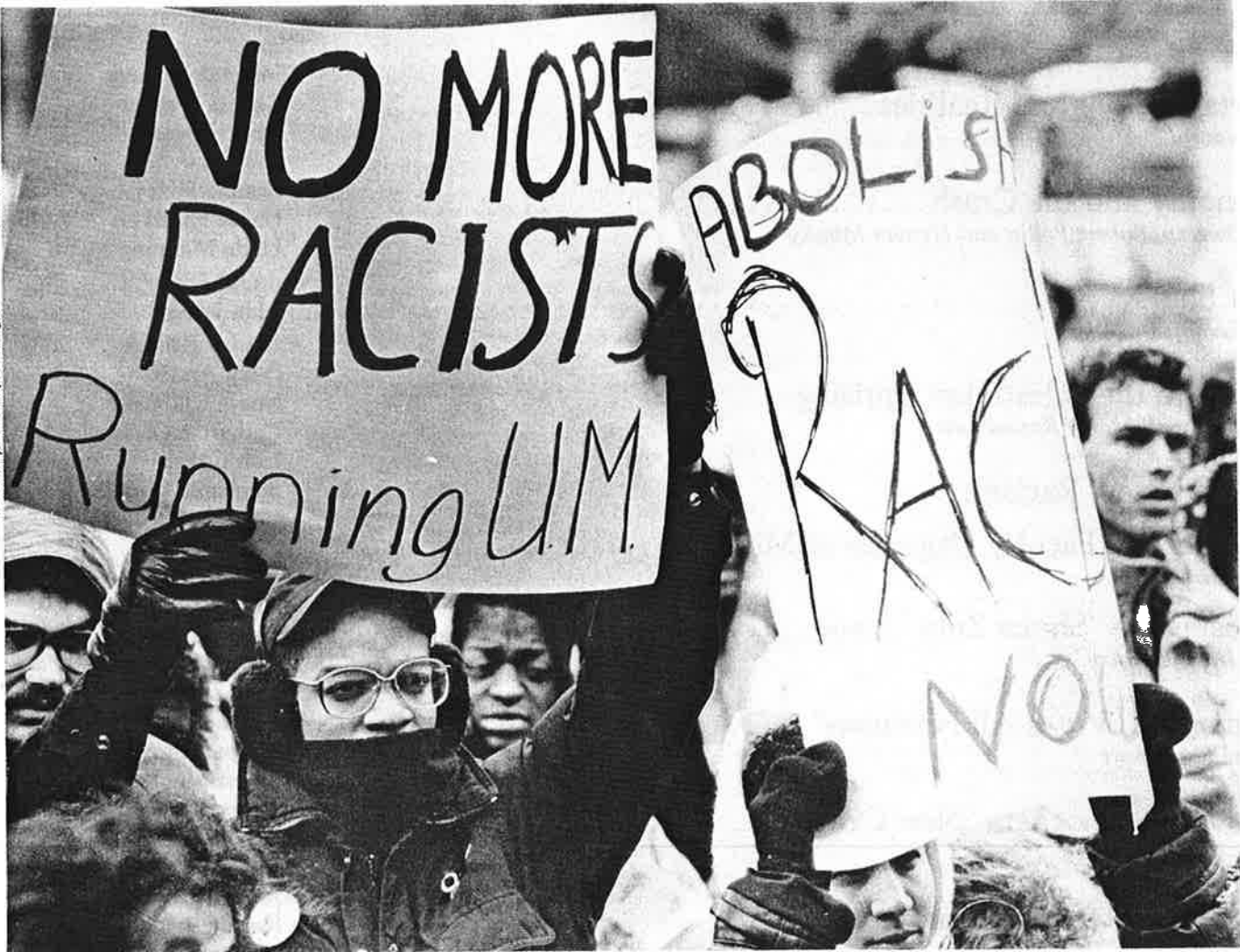


AGAINST THE CURRENT 14

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Noon Rally, University of Michigan, Ann Arbor, January 1988. John Munson, Michigan Daily



RACISM: NO PASARAN!

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In A World of Uncertainty

By Hyman P. Minsky

THE CRASH OF 1987 furnishes *prima facie* evidence that modern capitalist economies, with complex, sophisticated, and ever-evolving financial structures, are inherently unstable.

Over the years since World War II, economics has been dominated by doctrines—united under the broad umbrella of “neoclassical theory”—that yield the conclusion that free-market forces generated equilibrium results: steady growth, full employment of human and material resources, and stable prices.

The events of October 1987 have shown that eminent practitioners of this economic theory are as barren of insights into why financial crises occur as their predecessors in distinction were in 1929. They stand as the weavers and tailors stood after the little boy cried out, “The emperor is naked.”

Monetarism and supply-side economics are big intellectual and political losers. In general, all neoclassical approaches have been hurt, even though some of the new generation of practitioners are getting what they call “Keynesian” results out of the neoclassical approach. This success mainly is additional proof that well-trained and ingenious analysts are able to get the results they like by an apt selection of assumptions.

However, even the best of these neoclassical theorists do not expressly consider investment, its financing, the financing of capital-asset holdings, and banking relations, which are alike in that they set up cash flows — income and debt-servicing payments — through time. Henceforth institutionalist and Keynesian arguments that lead to a recognition of the flaws in capitalism, due to the time-dependent cash flow relations that are specific to capitalist finance, should carry more weight; and the neoclassical theories that have served as apologetics for capitalism should carry less weight.

What happened on Oct. 19-20 cannot

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be explained as normal, albeit not everyday, events by neoclassical economists. By contrast, post-Keynesian theory does argue that financial fragility will develop through the normal operations of capitalist economies. This is so because bankers, businessmen and portfolio managers react to profit opportunities by pursuing more aggressive and speculative financial practices, anticipating that the growth of debt will be matched by an increase in cash flows to service the debt.

Bankers as Gamblers

In a world characterized by uncertainty in the sense of Keynes, periods in which capitalist economies grow rapidly lead to widespread changes in perceptions and therefore in the “bets” that firms are willing to make.

The bets that firms make to finance their activities are revealed by the structure of their debt holdings. Bankers and money managers also place bets as they acquire the debts of businesses, households and governments, and as they incur debts of their own.

When a capitalist economy is functioning well, this means that all the economic players—businesses, bankers, governments and households—are willing to accept increased debt levels, on the bet that cash flows from incomes will also increase to service the debt growth.

Financial robustness exists when businesses and households have little indebtedness. When this is true, bank portfolios are heavily into government debt. This situation ruled for about twenty years after World War II.

History has shown financial robustness to be transitory. This is because it leads to experimentation and innovation by both lenders and borrowers, the effects of which build over time. The initially robust financial structure thus becomes increasingly fragile.

When a fragile financial structure emerges, conditions arise from time to time in which debtors are unable to meet their obligations through their normal income streams and therefore are forced to sell off assets rapidly to generate the needed cash flow. A fragile financial structure is a necessary condition for markets to perform in the manner we witnessed in mid-October.

The necessity for Federal Reserve “lender-of-last-resort” intervention to thwart a financial panic by supplying cash to the financial system and the power of such Fed interventions were once again made evident in October. The

central bank increased the cash-reserve base by some 2% in the immediate aftermath of the crisis (Robert M. Giordano, *Financial Market Perspectives*, Goldman, Sachs, December 1987).

This was the fifth time the Federal Reserve acted as lender of last resort in the 1980s. (The five are the Hunt silver affair in 1980; the failure of Drysdale Securities, a firm owned by Chase Manhattan Bank, in 1982; the simultaneous Mexican near-default and collapse of the Penn Square bank, also in 1982; the multi-billion bailout of Continental Illinois in 1984; and the stock market collapse in 1987.) Each time the Federal Reserve reacted by substantially increasing the cash-reserve base of the banking system.

The critical and most interesting day for economic analysis was Tuesday, Oct. 20. As the *Wall Street Journal* described it, by noon of Tuesday the stock market was ready to close, for sell orders so outweighed buy orders that if orders to sell were fulfilled the market would have been in a free fall. In particular, the great banks and security houses on Wall Street had become unwilling to invest any further in what they regarded as a free-falling market.

As this was taking place, Gerald Corrigan, president of the New York Federal Reserve Bank, was in direct contact with both the banks and the houses. Consistent with the New York Fed's responsibilities as lender of last resort to Wall Street, Corrigan guaranteed the banks and houses against further losses from financing market participants. As the *Wall Street Journal* reported, after Corrigan intervened the market turned around. The day ended with a gain.

It is worth noting that in the aftermath of the crash, Fidelity Investments, which offers over 100 money-market funds and which manages about \$80 billion, announced that it intended to increase its bank lines of credit. As a result, when it is again faced with a flood of orders from account holders to redeem their accounts for cash, it will be able to borrow rather than selling securities from its portfolio. The distress of October is thus inducing still another financial innovation—one that makes managers of money like Fidelity beholden to banks.

The New Capitalism

We might characterize what we have now as the “New Capitalism of Managed Money.” Over the ages we can distinguish varieties of capitalism: commercial,

industrial, financial, corporate and the welfare state. In the past decade a new form of capitalism has emerged, which reflects the increased "clout" of managed money. Pension funds, mutual funds, insurance companies and bank-administered trusts are now much more important than they were earlier in the capitalist epoch.

This money is managed to obtain the largest total return, that is, to maximize the sum of the cash flow in the form of dividends and interest and asset appreciation. Because of the weight of short-term asset price fluctuations in determining the total return, managed money is active money: managers pursue short-term asset appreciations by actively trading their portfolio.

Keynes distinguished between the returns from enterprise and the returns from speculation. Returns from enterprise are dividends, interest and retained earnings derived from productive investments. Speculative returns result from asset appreciations coming from asset-price fluctuations alone, not from increases in profits and retained earnings flowing from productive investments.

What we may call "managed-money" capitalism conforms to Keynes' definition of speculation. We can recall and paraphrase Keynes' remark that if enterprise is a mere bubble on a sea of speculation, the capital development of an economy is likely to be poorly done.

The growth of managed money brought into being institutions and ways of doing business that facilitated their operations and made them more profit-

able. One important innovation has been the emergence of block trading. Multi-billion-dollar pension and mutual funds deal in large blocks of shares. If these shares were sold or bought on the open market without any buffer, stock prices would change significantly simply on the basis of these firms' activities.

To prevent this, large blocks are not bought and sold by the block trading desks of the major houses. These block traders buy for their firm's account and then either dribble their holdings out in the market or find some fund that wants to acquire these shares or bonds.

Over Oct. 19 and Oct. 20, even as money managers were trying to sell securities, the block traders were both reluctant and increasingly unable to buy. Furthermore, because the losses of Oct. 19 had slashed the equity holdings of the block traders, on Oct. 20 banks began to withdraw credit from block traders as well as from the specialist dealers on the stock exchanges.

At this juncture the New York Federal Reserve Bank intervened. Its guarantees freed the flow of credit and got the block traders and others to once again take positions in the market. The 1987 crisis was resolved in a manner analogous to the way the much-studied British crises of the nineteenth century were resolved. The Central Bank intervened to prevent the market in general from collapsing, not to protect individual banks or speculators that were faltering.

Lender of Last Resort

We should now appreciate that one

reason why the fragile financial structure did not collapse between 1980 and 1987 is that the Federal Reserve, fulfilling its responsibilities as lender of last resort, intervened five times to sustain the financial system.

The Federal Reserve has demonstrated it can contain the dynamics that lead to chaotic financial markets and deep contractions in production and employment. The Federal Reserve, in other words, can sustain orderly conditions in both the financial and nonfinancial economy in the face of incipient crises.

The same history of the 1980s shows that the Federal Reserve cannot effectively control the growth rate of the money supply. This is contrary to assertions by monetarist economists, Milton Friedman being the most vocal. The periodic threat of financial-market collapse forces the Federal Reserve to abandon monetary-control policies in favor of lender-of-last-resort operations, feeding cash reserves into the financial structure.

This is the sense in which the money supply is "endogenous," that is, determined by forces inherent in financial markets, not, as the monetarists would have it, by the independent "exogenous" judgments of Federal Reserve managers.

Lender-of-last-resort responsibilities throw light on Paul Volcker's tenure as chairman of the Federal Reserve. He was more successful as a lender of last resort than as a controller of the money supply or of the economy. Because of the recurrent threat of financial crises, the quantity of reserve cash was endogenously determined by the need to maintain

A Visit to Ronnie's Astrologist



orderly conditions. The transitory success that was achieved in containing inflation in the 1980s was due more to wage constraint, resulting from the administration's trade-union bashing, tolerance of unemployment and accepting of imports, than to money-supply constraint.

"Will the events of October herald the onset of another Great Depression?" is a recurrent question. The first thing to remember is that the great collapse took forty months. It started with the stock-market crash of October 1929 and ended as Roosevelt was being inaugurated in March 1933. Much took place after 1929 that compounded the initial downward destabilization.

There is one great difference between the 1930s and the 1980s that has to be emphasized. Today the federal government is some 25% of the gross national product. In 1929 government was about 3% of GNP. There is a greatly simplified formula, usually identified with Michael Kalecki, a great Polish contemporary of Keynes, that reads: *profits = investment + the government deficit*.

If investment is 16% of GNP, there is no way the deficit of a 3% government can offset the effect upon profits of a sharp fall in investment. If government is 25% of GNP, then a fall in investment can be offset or even more than offset by the automatic deficit and some rather slight adjustments in tax and spending programs.

Profits collapsed in 1929-33; they cannot do so with today's structure of government-supported aggregate demand. I see no way a big-government capitalism can repeat the collapse of 1929-33.

In the 1929-33 contraction the stock market indices eventually fell to some 15% of their prior peak. One reason for this was the drastic decline in the profits of business over 1929-33. The decline in profits greatly diminished the ability of business to pay back its debts, and this adversely affected banks and other financial institutions. Today, big government sustains profits when investment declines by running deficits.

The Coming Recession

We are in Chicago, the Home of the Cubs, the site of the Henry Horner housing project, and historically a center of cynical and tough-minded thinking. We should be true to our hosts and recognize that the real welfare queens of late twentieth-century capitalism, the true beneficiaries of government deficits, are not recipients of Aid to Families with Dependent Children (AFDC) but profit, dividend, and interest receivers, whose in-

comes are sustained during recessions by government deficits.

The Kalecki equation opens up to: *profits = investment + the government deficit - the foreign trade deficit*.

The great turnaround in the United States trade picture during the Reagan years resulted in a drain of profits from the United States mainly to Japan and Germany. In 1988 a recessionary malaise is likely to spread over the economy, triggered but not caused by the stock-market crash. This will cut United States imports of manufactured goods and thus the foreign trade deficit. This will adversely affect Japan and Germany.

It will be up to Japan and Germany to maintain their prosperity by expansionary fiscal and monetary policies—substantial government deficits and low interest rates—if the recession is to be mild and short.

Whether or not there is a recession in 1988 that is prolonged and severe depends to a large extent upon whether Japan and Germany can maintain their prosperity without the help of a massive United States trade deficit. If they cannot maintain their markets open to imports even as they maintain domestic prosperity, then a new round of competitive devaluations and protectionist policies between the United States, Japan and Germany—reminiscent of the 1930s "beggar-my-neighbor" policies—is possible. If this happens, the recession will be pro-

longed.

The events of October and since constitute *prima facie* evidence that the price of non-interventionist, unregulated and small government capitalism is so high that it is a non-starter as a possible economic structure.

But this does not mean that the 1980 or 1987 structure of big government interventionist capitalism is the best we can do. We now appreciate that a structure of regulation and intervention once in place runs out of steam as time goes by and business and households learn how to avoid, evade and accommodate to the structure.

We now understand that programs that are not modified as avoidance, evasion, and accommodation take place are likely to become counterproductive—to lead to results that are not initially envisaged.

Thus the job of managing capitalism requires constant institutional reform, especially if the aim is to promote the development of resources, the enhancement of opportunity and the advancement of equality. Understanding of how in-place economic institutions work needs to be combined with constant institutional innovation if we are to achieve a closer approximation than we have hitherto attained, to what is, after all, the universal policy objective: a humane society. □

Corrections/Updates

DUE TO A typographical error, we garbled a sentence in Mel Leiman's article "Legacies of Soviet Planning" in ATC 12-13. The sentence should read: "It is essential to include agricultural production (*where the Soviet system has run less effectively*) as well as industrial production (where the performance has been much more effective), since the two sectors are intertwined, both historically and operationally." (p.28) The words in italic above were deleted.

The tribute to Jean van Heijenoort in ATC 12-13 ("Van Heijenoort Remembered," by Alexander Buchman) should have made clear that he died March 28, 1986.

Readers whose interest in Raya Dunayevskaya's work was stimulated by Richard Greeman's tribute in ATC 12-13 can contact News and Letters, 59 E. Van Buren, Room 707, Chicago, IL 60605, which publishes her writings as well as a newspaper of Marxist-humanist thought.

Mordechai Vanunu, the courageous Israeli nuclear technician, has received an 18-year jail sentence for revealing the extent of Israel's nuclear arsenal. Following sentencing he remained in solitary confinement as the authorities attempt to destroy him emotionally. Message of support and solidarity, subscriptions and magazines, books, etc. can be sent to him: Mordechai Vanunu, Ashkelon Prison, Box 17, Ashkelon, ISRAEL.

This issue of *Against the Current* has been produced with the desktop publishing equipment that generous contributions from ATC readers helped us to procure. □