

CREDIT AND FINANCE IN THE EMERGING "GREAT EUROPE"

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Meaning of "Great Europe"

We have to deal with two concepts of Great Europe. The first stretches from the western rim of Ireland to the eastern borders of Germany, Italy, Austria and Finland and mainly consists of affluent economies. The second has the Urals as its eastern border and the economies are far from affluent.

It is clear that the problems of credit and finance in the two Europe's are different. For the first the basic problems of credit and finance are the further development of financing relations and instruments for the in place successful people's capitalism and the avoidance of a debt deflation that could lead to a serious depression. For the second the problem is to set up a credit and financial structure that will expedite the transformation of command Socialist economies into economies that in time can be assimilated with the successful people's capitalism of the West. It would be more fun to talk only of the first but duty requires that I make some remarks about the second.

Finance and Credit in the Successful Capitalist Economies of Europe.

The most important economic development in the now affluent capitalist economies since 1946 is something that has not happened: there has not been a long and serious depression. The financial corollary of this development is that there has not been a debt deflation over this period.

This period 1946-1990 is unique in the annals of modern Capitalism. If we take the history of the American Republic as our guide, going 45 years without a great depression is unprecedented. Prior to World War II serious depressions were regular occurrences: Hard times were taken for granted. Recurring depressions meant that the working classes were always living on the edge of disaster. As a result of the depressions and the associated collapse of asset values the wide accumulation of albeit small net worths that characterizes modern affluent capitalism did not take place.

The capitalisms that broke down over 1929-1933 were small government capitalisms in which central banks were in varying degrees constrained by rules derived from the then current interpretation of how the gold standard worked. In the United States the break down of the financial system in 1929-33 was but another in a long line of financial systems that broke down. It is possible to write a history of the united states economy in which a major theme is the continuing quest for a financial system that gets things right, where of course getting things right meant different things to different players in the economic game.

One salient feature that differentiates the successful capitalisms of 1990 from the failed capitalisms of the 1930's is that the proportion of total demand that is due to the various Governments is now much greater than in the earlier epoch. Once again using the United States as a benchmark, the United States national government was but 3% of the economy in 1929: currently the national government runs to about 25% of the United States economy. Such big government is a common feature of modern capitalist economies. Such big government assures that when a depression or recession starts the downside pressure on aggregate profits will be bounded by the positive impact that increasing government deficits have upon total business profits. As a broad generalization we can assert that in 1933 laissez-faire capitalism was a failure and in the post war world an interventionist, welfare state capitalism has been successful.

A second salient feature of the 1946-1990 capitalist economies of the west is that central banks have been largely free to intervene as their wisdom indicates either to refinance units which the market no longer is willing to refinance or to "fix" or "rig" financial markets so that such refinancing is available. Sixty years ago gold standard rules fettered central banks in fulfilling their responsibilities as "lenders of last resort". The availability of refinancing means that the need for units to make position by selling out position is much reduced. This

reduces downside pressures on asset prices. Furthermore the rigging of financial markets by central banks makes bank funds available for the financing of economic expansion even as bank standards of what is creditworthy become restrictive. Post war recessions have been mild and short because of the stability of total profits that big government assured and the appropriate use of central bank powers.

A third salient feature of the era that ruled from 1946 until recently was the economic dominance of the United States. By maintaining a closer approximation to full employment over an extended period than ever had been hitherto achieved and accepting imports, the United States provided an environment in which Europe and the countries of the far east that were able to exploit the relatively open American economy could prosper. Whereas the United States was virtually the only country with fiscal independence in the 1946, today the United States fiscal independence has been much compromised by the international deficits of the 1980's. These deficits led to a vast accumulation of United States based assets by the economies of Western Great Europe and Asia: Today Germany and Japan may well be more independent fiscally than the United States.

As a result the loss of its dominant international asset position the ability of the United States to turn around the recession or potential depression that started at

the end of the summer of 1990 is quite uncertain. Successful contracyclical policy now requires that Great Europe and Japan cooperate with the United States. This need for the international coordination of contracyclical policies is an attribute of the world's credit and financial system in the 1990's

In examining the prospective evolution of finance and credit in the prosperous great Europe I do not feel that the evolution towards a common currency or even a coordinating institution for the Central banks really is of great significance. It really is much ado about almost nothing: the mere fact that Thatcher in her dotage is exercised about the prospect of a financially unified Europe is evidence that it really is not of great significance. What is significant is that Europe has moved to a system where the free movement of finance, in terms of both firms and portfolio diversification by institutions and persons has been well nigh achieved. It is portfolio diversification which determines that monetary and fiscal policies will be coordinated to maintain relatively fixed exchange rates. It the dominance of Germany's preferences and social institutions that allocate the gains from productivity increases to private and public uses in a non abrasive form that makes the coordination take on the anti-inflationary form it now has.

The trio of well nigh fixed exchange rates, the free movement of finance at both the portfolio and the corporate level, and the commitment to use domestic monetary, tax and spending to sustain the exchange rates means that the economies will be tied together. A unified currency and one central bank really doesn't add much. The important step is the movement to a system in which international portfolio diversification is not only permitted but encouraged and where businesses are free to cross what were formerly national frontiers.

The danger from a single central bank is that as a beurocratization rather than a political institution it may be more committed to fighting inflation than to the stability of the financial structure so that intervention to contain a potential debt deflation may be slower with a European Central Bank than with negotiating individual central banks. After all each of our great central banks has a history of dealing with complex situations that lie outside the theorists vision, whereas a unified European central bank will be the product of economic theorists. We must recall that the dominant economic theory finds no place for money, banks and financial contracts and we can expect those well versed in the abstraction that is modern economic theory to have little to say on how to handle financial crises.

Technologically driven changes

Whether it has been characterized by bank notes, deposits subject to check or some gyro system the payments mechanisms of capitalist economies have hitherto been tied into the credit and financial system. Money, as the payments medium and as an asset that has special risk return characteristics, was created as the banking system acquired assets and was destroyed as the commitments embodied in the contracts that banks held were fulfilled. One consequence of the technologically driven changes in the payments system over the past decade is that the relation between banks and the payments system has been much attenuated. Plastic, whether in the form of debit or credit cards, is rapidly changing the payments system in the United States. The plastic payments system increasingly reflects the power of electronics which has greatly increased the ability to communicate, compute and retrieve information.

There are costs to operating a payments system. In a bank based payments system the costs are in part or in whole carried by the margin between bank lending and borrowing rates. The payments system costs of the credit card system are paid for by a vender's discount: the vender's discount was the critical innovation in the development of the credit card. In a modern electronic credit card structure the vender uses a smart cash register which immediately

transmits the information about the transaction to the vender's card processor, which credits the vender's account and transmits the information about the transaction to the processor of the customer's card. The inter processor balances are now cleared by transferring bank balances but they could in principle be cleared by transferring some non-bank assets. In the near future household money and finance will revolve around the credit card. The traditional view of money as demand deposits and currency may well be well nigh obsolete by the time the year 2000 rolls around.

One aspect of the current financial crisis in the United States and the other affluent capitalist economies centers around the repercussions of the development of various financial funds which are the proximate owners of the liabilities issued by firms, households and government units even as the newly affluent classes hold positions in these funds. Because of the continuous flows of funds to these funds they are always seeking new assets. Securitization, the great newly expanding financing form of the 1980's, is a device that made securities based on mortgage and other previously institutionalized liabilities available as assets to mutual, pension and other funds. The great availability of funds seeking financial assets drove the financing that greatly increased corporate debts in the United States in the 1980's is one source of the instability that threatens the prosperity of the 1990's.

Debt Deflations

The financial structures of the advanced capitalist countries are now more fragile than they were earlier in the post war period. The progression of financial structures from being robust to being fragile is a natural and normal process in capitalist economies with sophisticated financial structures which evolve in response to market conditions.

Finance is an arena for capitalist entrepreneurship. New industries and new distributions of economic power and incomes and wealth give rise to opportunities for new ways to make on the carry and new ways to buy cheap and sell dear. When the financial structure is robust short term financing has a rate advantage over long term financing. This tempts entrepreneurial bankers and their business and household clients to experiment in new ways to finance long positions with short instruments. Furthermore a protracted period of economic prosperity affects the perceived risk-return relation of both lenders and borrowers so that even as debtor's financial commitments increase relative to their income flows the overt risk premium on financing in the form of interest rate differentials may be lower.

In the psychological environment created by a lengthy period of economic success lessons from history which indicate that highly leveraged positions are unstable are disregarded. This is especially true if the institutional

structure has changed: the appeal will be to some unspecified "they: who wont let financial instruments and capital assets lose their value. In truth the monetary authorities have limited powers and each exercise of these powers will have unintended and typically undesirable consequences.

We are now in the first stages of a recession in the United States. This decline of income employment and profits derived from United States private investments is taking place in the context of a greatly weakened banking system, the virtual disappearance of specialist house financing institutions (the savings and loan associations) from the marketplace, a large number of heavily indebted corporations and questions about the viability of pension funds and insurance companies. Because of the taut financing structure the lending criteria of banks has become tighter: the percentage of any package or deal that the institutions will finance has diminished and the various terms of loan agreements have become tighter. As a result a feedback process among the income and profit determining processes and the viability of the financial structure processes has been or could be set off. In simple terms what every unit does in order to protect its own interests makes things worse not better: the inverse of the Smithian invisible hand rules the market place.

The Second Concept of Great Europe

The breakdown of the Soviet block has made it clear that Capitalism is first of all a financial system. The transition from the Soviet model of Socialism to a decentralized market economy requires that the production and distribution structure be broken down into enterprises that in turn can be valued. But the only value that an enterprise or a collection of capital assets collected into an operating unit has is derived from the profits it is expected to earn. The creation of enterprises and the establishment of profit expectations that lead to a value for the enterprise is the central problem of the transition.

However there is a prior aspect which cannot be neglected. In a socialist economy households do not have significant amounts of wealth. Even if value can be placed on assets and enterprises there is no demand side to the market that would be derived from the wealth of individuals. A transitional form of ownership and management is required before major privatization can take place.

It is impossible to create a capitalist financial structure when virtually none of the information that would make for a valuation of the assets in the economy is available. Furthermore it is clear that much of the economy needs to be operated with a net cash flow out to cover operating losses and to pay for the refurbishing of plant

and equipment. Thus the state or state agencies need to play a large role in developing an economic structure that can generate the information which is needed for setting a price on enterprises.

Capitalism is a two price level system: there are prices for current output and for capital assets and financial instruments taken together. The history of the Socialist economies furnishes no material for the determination of the capital asset price structure. Furthermore there are no portfolios in the economy that provide markets for the instruments that are used to finance positions in capital assets.

Before the eastern economies can be fully privatized there will be a need for a period in which the dominant financial organizations are not private but rather public holding companies which own , but do not operate, enterprises. The function of these public holding companies is to create firms with a history of profits so that a rational man in an uncertain world will hazard taking a position in the liabilities that finance these profit earning assets.

The model for the construction of a financial system for the Socialist economies is not some abstract market economy. The Sloan structure of General Motors, the finance Committee structure of Exxon are examples that should be studied. These were in effect private holding companies

with competition in the market and for finance among the various operating units. Another example is the Reconstruction Finance Corporation of the United States and IRRRI of Italy. At present it seems as if Germany is going the public holding company route for the transformation and Integration of East Germany.

Conclusion.

The financial transformation of Europe in the 1990's has two aspects. One is whether the financial system of the affluent Europe will be able to support the continued adequacy of total demand in the light of the transformations that the United States is undergoing: What will affluent Europe do without the economic umbrella from the United states.

The second is whether the countries of the East will stop trying to establish some abstract market economy and will turn to the development of financial institutions that can support industry as it develops a profit seeking orientation and generates a history fo earned profits so that enterprises can have value. In this endeavor the countries of the East cannot be ideological, they must be pragmatic. The practical problems seem to require that a Public Holding Company needs to be a main player in constituting a financial system that will make progress towards assimilation with the west possible.