Introduction

Money, Banking and Finance and the Performance of
End of the Millennium Capitalism

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As the twentieth first century draws near it is clear that the economic landscape is far different from that which ruled as recently as January of 1981. When the 1980's dawned the United States was the unquestioned leader of the capitalist world: this leadership was economic, political and militarily. True countries of the common market and Japan were more significant economically and politically in 1981 than in 1971 for their expansion was at a faster rate than that of the United States during the 1970's, but that was an expected and desired outcome. Expected for imitators of what is successful in technology are expected to expand at a faster rate than the economy that is dominates the technology and productivity frontier. Desired, for it was American policy to promote the growth of these countries.

The United States was the dominant financial power in the world. By 1980 the deficits on trade account of the United States were of the correct order of magnitude for a dominant economic power. In a system of international portfolio diversification, the country with a large net holding of foreign assets needs to run deficit on current trade account so that the rest of the world can earn the income in the currency of the creditor country that is needed to service their debts. The imbalances that had characterized the first decades of the post war world were rapidly becoming a thing of the past in the 1970's. An era of strong prosperity for the United States and its trading
partners seemed inevitable. However the impact of inept economic policies should never be underestimated: A new set of economic imbalances, fostered in good measure by irresponsible United States policy which ignored the elementary proposition that liabilities have to be serviced, appeared as the decade advanced.

As the 1980's began the main economic and social problem in the international sphere was the rivalry for military dominance between the United States and the Soviet Union. This dominance of the political and military rivalry had been true for more than 30 years, ever since the cold war began in Berlin in 1946. Now that problem is history: containment, the wise policy of Truman, Acheson and Marshall which relied upon economic prowess as the ultimate arbitrator, won.

The dramatic collapse of the Soviet Union in 1991 marked the end of the Soviet model of Socialism as an economy and as an alternative to capitalism. In 1991 the economic policy problem, in what had been the Soviet world, became the need to put the institutional structures of a modern capitalist economy in place. This is much more demanding than the vulgar freeing of markets and of prices that became the model of the transition. The monetary and financial system is the main institutional structure that has to be developed for a transition from a Soviet type socialist state to a capitalist state to be successful. The monetary and financial system includes the arrangements for
the ownership for capital assets and the systems which finance the capital development of the economy.

Economic development of a capitalist economy is not simply a matter of accumulation or of technical innovation, it is a matter of mobilizing and allocating finance to resource which are used in the accumulation process. This requires that there be in place a mechanism for valuing capital assets, which are in a real sense each days inheritance from the past. Such a valution can be made only if there is some way of estimating the future incomes and costs that in some sense are attributable to the outputs which the capital assets will help bring to the market. No matter what else may be true, such estimates need past or analogous performance histories for the data to be believable.

But the problems of creating a financial system for the former Soviet world is not the only financial problem that requires political will and creativity if the new century is to be ushered in style.

In Western Europe, during the last decade of the twentieth century, present plans call for financial integration to catch up with the industrial and commercial integration which has made the new prosperous Europe. Whether the breakdown of the east slows the process of financial integration or accelerates it, the financial structure of Western Europe will be substantially different in 2001 than it was in 1981.
Japan and the other export oriented industrialized countries of Asia will need to adjust to their new positions of power in the economic and financial structure of the World. In Japan there are many signs of stresses and strains in their financial structure.

The countries of Latin America were worse off as the 1990’s started than they had been a decade or so earlier: the 1980’s were a lost decade for Latin America. Their financial structure needs to be reformed if it is to become a vehicle for the capital development of the economy. The economies of Latin America remain failures as the century ends.

The financial system of the United States is not in an overt crisis as it had been in the 1930’s. This may be so because the Federal Government is pumping huge sums of money into the deposit insurance facility in order to keep the market values of deposits at par. In the 1991 legislative year, as part of a package which refinanced the deposit insurance funds, the Administration proposed extensive changes in the financial structure. This package of reforms were largely rejected by Congress. Legislation was passed which increased the powers and the options of the regulating agencies: this went in the opposite direction from what the administration had proposed. Financial institution reform will remain on the United States’ legislative agenda.

It is evident that legislation to create, reform or adjust financial systems is now on the political agenda
throughout the globe and will be there for the foreseeable future. Furthermore the financial system will be in a period of accelerated change as individual units try to adjust their behavior to changing market conditions.

Innovators operate in financial markets as well as in product markets and in the design of production processes. If the financial structures that are created or reformed are to work well it is necessary that they be guided by an understanding of the mechanics of financial systems and what we can expect financial systems to do. Therefore the practical problems of how do we create a financial system or how do we adapt our financial system to changing conditions requires an understanding of how a capitalist economy actually works. We need a theory of the capitalist economy rather than a theory of an abstract economy. Thus we will begin with some general considerations of the functions of price in a capitalist economy and how they are formed.

Some Fundamental Considerations

A complex and sophisticated financial system is the defining attribute of a modern capitalist economy. Traditionally capitalism is characterized as an economic system in which the means of production are privately owned. For the world as it is at the end of the 20th century this is not quite accurate. For modern capitalism a distinction
has to be made between the "proximate" and the "ultimate" owners of the means of production. In a modern capitalist economy almost always the proximate owners are corporations (or endowments and governments) whereas the ultimate owners are individuals or collectives, such as endowments and even government units.

Some will say that our definition of modern capitalism is dirty, that a pure capitalism would not allow for endowments or government ownership.

Each corporation has a balance sheet on which its assets are listed and values are assigned to each asset and similarly for liabilities. Because these balance sheets need balance - hence their name - any change in a balance sheet item requires an parallel change which keep assets equal to liabilities. This becomes of special importance when market values are used in valuing assets, for when market values change then the values of some liabilities have to change. The equity liability is the balance sheet entry that absorbs capital gains and losses.

Liabilities are promises to pay. These promises to pay differ in their place in the line of claimants to the earnings and to the property that is owned by the corporation. As a result of these differences, and differences in the position of the various enterprises in the economy, liabilities differ in their surety, in the likelihood that the commitments they embody will be fulfilled.
The liability structure of an organization can be interpreted as a time series of payment commitments. These commitments are demand, dated and contingent. For each period the outstanding liabilities of an organization are a prior commitment of the income that the organization receives. At every moment of time the liability structure of an organization can be read as a time series of dated commitments, an outstanding amount of demand commitments, and a set of payment commitments which are contingent in amount and time.

Borrowing and lending, based upon margins of safety, was in Keynes’ view a marked characteristic of the economy in which he lived. It remains a marked characteristic of modern capitalisms.

The nominal owners of the private wealth of a modern economy possess financial instruments. These instruments are claims on the income and property of either some corporation or some financial institution. These financial institutions in turn own either liabilities of corporations, which are the proximate owners of the productive instruments of the economy, or liabilities of other financial institutions.¹ Financial institutions intermediate between the operators of the capital assets of our economy and the ultimate wealth owners of the economy.

As a result of the layered financial structure which now exists the cash that a wealth owner receives in the form

¹. Governments and foreign assets and liabilities are ignored in this exposition of fundamentals.
of interest, dividends and rents is likely to have followed a complex path from a business through a string of financial institutions such as banks, insurance companies, mutual funds, pension funds etc. etc. before becoming either his income or a repayment of some outstanding principle. This flow of cash, from corporate earners of gross capital income, gross profits before taxes in the usual parlance, to the ultimate holders of wealth travels by way of intermediaries which issue their own liabilities in order to acquire the liabilities of other units.

Each intermediary requires the use of resources in the form of labor and capital. In a capitalist economy these intermediaries are profit seeking firms: there are owners and managers of these enterprises who seek their own gain. This profit seeking characteristic of financial institutions means that finance is Schumpeterian, in that innovations occur which lead to new ways to finance demand and positions in assets, to the creation of new instruments for the portfolios of wealth owners as well as financial intermediaries and to the "invention" of new types of financial intermediaries.

Finance is an entrepreneurial activity. Not only does innovation takes place in finance but product and process innovation in business often leads to the need for the financial system to adjust to new financing requirements.

Because each financial institution is profit seeking and has labor costs and capital invested, not all of the
cash flows that operating units send on their way towards the ultimate owners of wealth end up as incomes of the ultimate owners of wealth. Cash flows from the operating units of the economy are absorbed as wage and capital costs of intermediaries.

We now make some adjustments to the contemporary reality. In the modern world businesses are not the only sector of the economy that serve as ultimate units in supplying assets to the banking system: households, governments and foreigners are additional ultimate units that supply assets to financial intermediaries, which then flow on to households. In particular the modern credit card has made credit, and therefore command over goods and services, available on demand to a vast proportion of households. Governments have become chronic borrowers.

The existence of an outstanding stock of household and government debts means that there are also cash flows from household incomes, largely wages, and government incomes, mainly tax receipts, through financial intermediaries to the households which are the ultimate owners of wealth.

One implication of the development of ready credit for households especially the development of credit cards is that the ratio of households spending to household income can vary quite markedly over a short period of time. This as we shall argue, increases the volatility of aggregate profits.
The money flows imposed by any time period's inherited financial structure show that a flow of cash goes from the profits, wages, and taxes of the income production system to financial intermediaries and then on to the ultimate owners of the economy's wealth, the households.

In the structure of financial linkages, the commitments to make payments are in some agreed upon instrument, the money of the transaction and financing network. The current periods money flows that sustain the financial structure, and thereby validate contracts entered into in the past, and which take place as additional debt financing occurs link the economy's yesterdays, todays and tomorrows.

Today is both a tomorrow of day's past and a yesterday for today's tomorrows. Past commitments are falling due today even as commitments are being made today which will fall due in the future. Furthermore the ability of units to fulfill the commitments made in the past that fall due today depends upon the commitments to make payments in the future that are being made today, and the repercussions of the current demands that are being financed by the cash that these commitments bring.

A capitalist economy can be characterized by the cash flows that reflect the various types of productions, the various types of income payments, the financing of investment output and the dealing in real assets and financial instruments.