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Flow of Funds and Cash Flows

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The balance sheets of various units - be they households, ordinary business, financial business or governments - set up cash flow commitments and expectations of cash flow receipts. These commitments may be demand, contractual or contingent. In addition units can obtain cash by dealing in the instruments: either by creating new instrument (borrowing) or by selling from their portfolio. At any moment of time these balance sheet payment commitments are a set of 'predetermined' variables which affect units decisions and affect the impact of monetary and fiscal operations.

The liability structure finances positions in assets. In ordinary business firms the essential position consists of real capital assets. These real capital assets are expected to yield a cash flow, the quasi-rents of Marshall and Keynes. These quasi-rents are equal to the sum of profits before taxes, capital consumption allowances and interest payments (ignoring the incentives and foreign branch profits lines in the table). From this gross cash flow profit taxes, interest payments, and dividends are deducted to obtain the Flow of Funds account item Gross Internal Funds. It is my view that for increased usefulness the various sector accounts in the Flow of Funds accounts should be adjusted so as to have an item labeled "cash flow available to service liabilities" i.e. the gross quasi-rents of the corporate sectors.

Similarily it is desirable that the various liability items in the firm's balance sheet be transformed into a current cash payment requirement. The relation between the income account cash flows to and the balance sheet cash flow commitments determines a units vulnerability to financial shocks - it determines to what extent a sector needs to turn over or refinance debt in order to meet payment commitments and the extent to which its viability is dependent upon the normal functioning of financial as well as product and factor markets.

"Investment", to a large extent, is the result of corporate behavior. The investment, in particularly fixed investment, of any period is the result of past dedisions. Investment sets up cash payment commitments. Investing units no doubt have financing plans in which retained earnings (gross) and external finance are combined to finance each period's investment. The ratio of corporate investment in plant and equipment to internally generated funds is indicative of whether additional corporate debts or new issues of corporate equities are needed.

To a corporation the payment commitments on outstanding liabilities plus the payments on ongoing investment programs are claims against the gross cash flow. To the extent that short term debt is falling due and the investment programs exceeds the cash receipts from operations and owned financial assets a firm must externally finance a portion of its cash needs. In order to protect itself from unforseen contingencies which may affect either its cash flows from operations or the markets in which it borrows, the firm will have a safety fund of cash or readily marketable financial assets on hand.

By their very nature the assets in this 'safety fund' earn little in the way of observed yield - their value to the firm is as insurance. How much insurance to carry depends upon the expectations that unfavorable events will take place and the cost in terms of observed foregone income from holding cash or highly liquid assets. Thus the main speculative demand for money and near monies depends upon the views held as to income flows and financial market behavior over the periods for which liabilities are dated.

But these "future" monies are really not known, neither in terms of their expected value or in their variation around their expected value - Businessmen play a mixed game of chance and skill and as expectations are satisfied or more than satisfied they visualize favorable "chances" - as expectations are disappointed they visualize unfavorable "chances". These chances are immediately reflected in two items, the pace at which they want to invest and the liability structure with which they wish to finance their position.

At this point I might as well cite from The General Theory...

"Two types of risk affect the volume of investment which have not commonly been distinguished. The first is the entrepreneurs' or borrower's risk and arises out of doubts in his own mind as to the probability of his actually earning the prospective yield for which he hopes".... [p.144]

But where a system of borrowing and lending exists, by which I mean the granting of loans with a margin of real or personal security, a second type of risk is relevant which we may call the lender's risk. [p.144]

During a boom the popular estimation of both these risks, both borrowers risk and lenders' risk, is apt to become unusually and imprudently low. (p145). I might also add that after a financial crisis the popular estimation is apt to become unusually high.