The Transition to a Market Economy: Financial Options

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INTRODUCTION

The transformation of society in Eastern Europe has proceeded much faster and the destruction of the legitimacy as well as the efficacy of communism has been more complete than was deemed possible when we last met here two years ago. Like all revolutions it has not been a reasoned and deliberate process: no one has been in charge and no coherent view of the society the revolution aims to achieve has emerged. The purported aim of achieving a market economy is no aim: there are many varieties of market economies, the concept is not precise.

The transformation began without any serious body of available literature on problems of the transition from a command or planned socialist economy to capitalism or even to a market economy, whether capitalist or socialist. As a result the process has been both rapid and helter-skelter: furthermore there is a great deal of public impatience. It is understandable that the idea that real results take time is not popular in societies in which so much has been sacrificed for so long to build a better tomorrow only to learn that no such building was taking place.¹

¹. It almost seems self-evident that the so-called planned economies were not in any serious sense planned. In serious planning the interdependent relations in production and consumption are considered. The apparent disregard of the conditions of the labor force and of the environmental impact of industry in the Eastern European economies is prima facia evidence that interdependent relations were disregarded, i.e. development was anarchic not planned.
There is little in the discussion that I know of, and I do not claim to be into the large literature that I am sure has developed on the subject of the transition, about the salient fact that differentiates market economies, whether conservative capitalist or social democratic, from the economies based on Leninist - Stalinist principles. The salient fact is that market economies are financial systems in which personal incomes are derived from the profits made by industry and trade.

Financial systems consist of institutions, instruments and markets by which commitments to allocate future income to fulfill financial contracts are made and once made can be traded. Each unit in the economy has a balance sheet in which real and financial instruments are entered as assets and the liabilities of these units consist of financial instruments and the units net wealth. The units net wealth is the arithmetic difference of the values assigned to the entrees on the asset side and those on the liabilities side. Thus there are commitments to make payments in the future by some units in the economy which are owned by other units. Ownership of financial instruments implies that there are claims in place which are expectations to receive incomes in the future. These commitments are first created in an exchange where money is paid today (or promises to perform are made today) in exchange for particular claims to future incomes or cash flows. The cash flows from organizations
which operate the economy’s capital stock, above what is needed to meet wage bills, tax bills and purchases from other units, to the holders of financial instruments (whether explicit as interest, dividends, and repayments of principle or implicit as in the case of corporate retained earnings) are conventionally called gross profits. As a result of the complex of contracts entered into the past, the cash flows (as defined above) that are realized at any date are allocated among claimants as stated by the stock of outstanding financial instruments and entries on the books of financial institutions.

These claims are accepted as legitimate because the right to these cash payments were created by prior payments: rents, interest and dividends are legitimate because they reflect the money later part of trades in which money now was exchanged for money later. The money now paid for investment output, state spending or foreign goods. Those who acquire financial instruments from the market after they have been created in some initial financing transaction acquire legitimacy for their claims from the original transaction.

It is obvious that questions of the legitimacy of rights to future income can arise in the privatization of a public domain: the difference between the honest homesteader and the Robber Barons in American history comes to mind. The lesson from history is that the privatization of the public domain should be done very carefully, especially if
the capital assets in the public domain were created without any explicit or tied private financing. Questions of how to create legitimate titles need to be addressed in discussions of the transformation of Eastern Europe.

In a capitalist economy investment and positions in capital assets are financed by exchanges of money now for money later. The receiver of the money now presumably uses the funds to invest and has an acceptable answer to the essential banker's question "How are you going to get the monies to repay me?". (The money now for financing investment includes earnings retained rather than distributed; presumably the in-house decisions relating to retained earnings pass the same test as external financing. We also know that there are many cases where the presumption is unwarranted.) The financial system thus provides for linkages through time: exchanges of money for well-defined claims to future money flows are made each day. Furthermore each day is the future of deals that were struck in the past... The financial structure and the physical capital assets of a capitalist economy link the present to the past and to the future.²

Because financial linkages in a capitalist economy between the past the present and the future are always conjectural, simple linear models that abstract from money

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² In a Leninist-Stalinist socialism the link of today to the past is through the labor force and the capital assets available for use today and the link of today to the future is by way of gross investment, labor force development processes and the labor and capital that is carried over.
and finance violate the true character of a capitalist economy. In particular business cycles, that are linked to endogenous financial crises, and the pay off from government regulation and intervention, which prevent or contain crises and depressions, are non starters in an evaluation of the costs and benefits of a regime, when a theoretical structure where money and finance are ignored is used for policy making and policy evaluation.³ Policy making for the economies that are building market economies from so to speak scratch should take the advice of those who's basic economic theory either ignores finance or reaches the conclusion that finance doesn't matter with the proverbial grain of salt.

As a result of financial linkages economists are recognizing that capitalist economies are best modeled as complex non-linear time dependent systems then it follows that the path through time of capitalist economies are likely to exhibit periods of incoherence, of instability that is due to the characteristics of the system rather than to any inept or malevolent shocks.⁴

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³. The Savings and Loan crisis in the United States is a result of the gradual deterioration of the regulatory system over the post war period (1946-80) and an abrupt corrupting of the regulatory system in the 1980's. What is being called a bailout is the use of government fiscal strength to prevent the breakdown of the S&L's from triggering a big depression. Because the government is being operated by those who accept the advice of good ole neo classical economists - in neoclassical theory finance and therefor money really do not matter - they know not what is happening and they therefor know not what to do.

⁴. It is well known that multidimensional non linear time dependent systems are almost certain to generate complex
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There are many different financial structures in history, in existence and in our ability to invent. The impacts of these different financial systems differ in how they affect not economic efficiency and stability but also the distribution of power in the economy. In particular they can affect whether power is concentrated or diffused. Therefore there are choices that need to be made, options that need to be considered when eastern Europe addresses questions about the structure of financial institutions.

THE SURPLUS AND FINANCE.

In any economy where investment takes place - or where there is a court, an army, a priesthood or production for the use of foreigners - the total of wages paid is greater than the wages paid in the production of the goods the wage earners will buy. Put it simply the workers producing investment output or who serve the parson of the Prince have to eat. As a result the price of the goods wage earners buy

time paths. If economies are modeled as such systems then fully endogenous incoherent behavior will take place. In such models runs of coherent behavior are the result of interventions and constraints. The floors and ceilings business cycle models of some 30 years ago can now be generalized. For an exposition of the economics of chaotic systems see Baumal and JEL 1989,

For floors and ceilings business cycle models seeJR Hicks

HP Minsky "Monetary Systems and Accelerator Models" AER, 1957 and HP Minsky "A Linear Model of Cyclical Growth." RE...STAT 1959
is greater than the labor costs in producing these goods. This elementary relation indicates that there will be a surplus: gross profits will be earned in the production of consumer goods and these profits will depend upon the relation between the total wages paid for the production of consumers goods and the total wages paid in the production of investment goods.

In a capitalist economy the surplus that is forced by investment spending takes the form of profits. Capitalism is characterized by two phenomena that follow from the financial system: the allocation of the gross profits of the economy among claimants and the financing of sufficient spending so that the composition of demand generates a surplus, i.e. profits, depends upon the adequacy of spending financed through the financial system.

At the level of the individual unit and the particular financing deal, the financing of investment takes place because a pro forma (a projection of revenues and costs, of cash flows) convinces the businessman and the financier that the project will be profitable. The businessman answers the financier's question "How will you get the monies to meet the obligations to pay you are accepting?" by pointing to the prospective cash flows.

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5. For a further explication of these relations see M. Kalecki and S. J. Levy and H. Minsky STABILIZING AN UNSTABLE ECONOMY.
Assumptions about future economic conditions underlie these pro formas. When the construction and land development deals that have undone the S&L's in the United States were entered upon a not unusual assumption was that oil was heading towards ninety dollars a barrel. A bankers cliche is "I've never seen a pro forma I didn't like," i.e. those seeking financing always present a favorable view of what will take place. In the business of capitalist financing it is the duty of the banker to be the skeptic. One suspends disbelief when one goes to the theater, but one does not suspend disbelief in the board room where financing decisions are made. If aggregate economic conditions and the behavior of the local economies that were assumed that were assumed in the pro formas drawn up in the 1980's were being realized in 1990, there would be no S&L debacle in the United States.

The financial system of a capitalist economy allocates the realized surplus to individual claimants - creating interest, dividends and retained earnings incomes. It also uses the financial system to finance investment, government deficits, export surpluses, and consumer spending in excess of income. The operations of the financial system finances demands that force a surplus out of the economy. Financed investment, financed government deficits, financed trade surpluses and financed consumer spending in excess of

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6 I wish to cite what I call William Janeway's first law, "Entrepreneurs lie." Minsky's corollary is "Banker's also lie."
Consumer incomes forces the surplus which takes the form of money flows that may or may not be large enough to validate claims to income that are legacies of past financing decisions.

I state these elementary truths in order to make the point that a financial system needs to be created as a socialist economy becomes a market economy. However the revolution is so profound and so wide that it is impossible to create reasonable or believable pro formas, to project future profits, for either existing enterprises let alone for new projects. This implies that the financiers will be required to make great leaps of faith, which in the light of the continuing problems with the recent leap of faith in Latin America seems unlikely or that the financing of investment will be based on considerations other than the projections that make up a pro formas. Financing, whether domestic or foreign, in the absence of acceptable pro formas will depend upon political considerations. The political considerations will either be domestic, which implies a socialization of the investment process, or they will be foreign, which implies a dependency status for the newly emerging economies.

7. This phrase consciously echoes Keynes.

8. As a result of the great collapse of the financial system between 1929 and 1933 sufficient investment to generate a close approximation to full employment was not being financed on the basis of "believable" pro formas generated by private businesses. Keynesian deficit financing was a substitute for private investment in both generating income and forcing a surplus (profits) on the economy. Government guarantees of private financing was a way to generate
FINANCING SYSTEMS

There are great differences in the financial systems of the various capitalist economies. Furthermore the financial system in any economy at any time differs from the financial system of the same economy at an earlier or a later date. Financial systems of capitalist economies evolve in response to perceived profit opportunities in financing and refinancing businesses, households and governments and in adjusting liability structures and portfolios. Financiers are profit seeking business men and financial innovation is an endogenous phenomena. Even without the prompting of Professor Schumpeter, J. P. Morgan well understood that the acquisition of market power was the way to acquire assured profits for particular organizations once the macro economics were such as to generate adequate aggregate profits.

As a result of the impact of the financial systems of capitalism upon the decisions that can be implemented, the actual operations of a capitalist economy differs from the acceptable pro-formas so that private financing of was available for private. The seeds of the 1990's S&L debacle, which rest upon government guarantees of private financing, were planted in the 1930's.


10. Joseph Schumpeter "THE THEORY OF ECONOMIC DEVELOPMENT" Harvard University Press 1936 is the classic English translation of a volume that had appeared in German some 30 years earlier.
that of the models developed in the formal theory, where the analysis is carried out abstracting from the existence of money. Theory that abstracts from money and finance, such as Arrow Debreu, Arrow Hahn and even the scribbling of monetarists, are poor guides for understanding problems involved in the transformation of the hitherto socialist economies into capitalist economies. Analysis which abstracts from money and finance cannot be expected to lead to blueprints for the design of the financial institutions of newly emerging market economies.

The critical problem that the transformation needs to solve is: create a monetary and financial system which will facilitate economic development, the emergence of democracy and the integration with the capitalist world. In this transition the control of property needs to move from the planning authorities to decentralized production units (enterprises) and the objective of managements needs to be the earning of profits in the market.12

The Heinz Company, the well known canner of pickles and purveyor of ketchup used to have a slogan 57 varieties to describe the wide scope of the products it offered. I used

11. K. Arrow and G. Debreu
K Arrow and F Hahn
M. Friedman
D. Laidler

12. Note that there are models of Socialism in which decentralized enterprises seek to earn the best possible profits in decentralized markets. Oscar Lange "ON THE ECONOMIC THEORY OF SOCIALISM", University of Minnesota Press is the classic statement.
to say that there are as many varieties of capitalism as Heinz had of pickles, and that this very variety of the capitalisms that are in place or which have been in place or which will be put in place is responsible for the resilience of capitalism. Capitalism is both intermittently fragile and resilient. Even as events show that a particular form of capitalism is a failure - as the great depression showed that small government laissez-faire capitalism was a failure - other forms emerge. Thus the emergence of big government interventionist capitalism in the period leading up to and after the second World War was a response to the failure of capitalism between 1929 and 1933.

This form of capitalism had a successful run of about forty years in the United States. The current problems of American Capitalism may be interpreted as the aging of the 1933-36 Roosevelt reformation of capitalism and the futility of attempting to reform that now aged capitalism by returning to the failed model of the pre 1930's era. European capitalisms, where the use of the state for public purposes is in better repute than in the States, may be more successful in the foreseeable future because it is more flexible. Japan is off on a different course of a controlled and manipulated market economy which so far seems to need to sustain its flow of profits by massive export surpluses. Japan's prosperity may be very fragile, for it seems to depend upon technical virtuosity and strong export surpluses. Given its acquisition of foreign assets Japan
has to turn into an import surplus economy if the profit
flows of those who owe it money are to be able to sustain
the financial assets Japan now owns.

The existence of a wide variety of capitalisms and a
wide variety of capitalist financial structures makes the
problem of designing the financial system for the economic
order that will form in the newly emerging economies to the
east of the common market more difficult. It also makes an
understanding of the alternative financial structures which
are possible and their likely impact upon efficiency,
development and distribution important as we begin to write
on the largely blank slate that is Eastern Europe.

BALANCE SHEETS

A fundamental attribute of capitalist economies is that
each unit has a balance sheet and these balance sheets are
interrelated. The capital assets in the economy, the
plants, equipment and land that constitute the basic non
human productive capacity of the economy, are one set of
assets in these balance sheets. In the early stages of
capitalism, before the rise of the corporation and when
yeomen or lords owned land and say cattle, the actual real
things may well have entered the (implicit) accounts:
accounts were more like inventories than balance sheets.
But as soon as the operator or the ostensible owner of
assets began to finance part of the "position" in assets with financial instruments that were promises to pay money, the simple enumeration of assets had to be replaced with a value of assets. It is convenient to value assets in the same unit (currency) as the debts are stated.13.

In a modern capitalist economy simple private ownership has been replaced with corporate ownership: the proximate owners of capital assets are now corporations. Furthermore, corporations often have complex liability structures. A complex combination of equity shares, bonds, mortgages, leases and bank loans finance the control of the capital assets that are needed for production.

In such a modern corporate world the liability side of the balance sheet has to be interpreted as a claim by other units to cash payments: liabilities of one unit are assets of another. The various instruments used to finance the position are dated, demand or contingent claims to the cash flows that the operations of the unit, operations that depend upon the use of the physical capital assets, generate. The time dimension, which is an essential aspect of capitalism arises once there are financial liabilities, for unless the claims to cash are all contingent, i.e. they depend upon the performance of the organization that issued the liabilities, the commitment to make precisely defined dated payments are entered upon before the funds are

13. This sentence echoes Keynes and is a postulate that leads to the liquidity preference theory of interest and asset valuation.
realized. The performance in the present may or may not validate commitments that were made in the past. These intertemporal and contingent natures of the financial relations of a capitalist economy are the essential reason why capitalist economies are not likely to behave in a nice equilibrium seeking way and why interventions into markets are often necessary.

The real assets in the balance sheet of productive units are not liabilities of any economic unit. The liabilities that are used to finance these positions are in turn assets in other balance sheets.

The paper world of financial instruments connects various balance sheets. In simple financial worlds the liabilities of production units would be assets in household balance sheets and households would directly receive the payments committed on these liabilities. In modern capitalist economies many balance sheets are interposed between firms that are the proximate owners of capital assets, and household who are the ultimate owners of the wealth of nations.14

The simplest intermediary owner of the liabilities used to finance positions in capital assets are banks, which interpose their guarantees between the operator of capital assets and the owners of bank liabilities. The power of this guarantee has been such that bank liabilities became

14. There are organizations such as Universities with their endowments who are artificial households.
means of payments, became the money of the economy. The holding of bank liabilities were deemed to be a secure and necessary part of the wealth holdings. Because of the ways in which the profit driven creation of the means of payment was able to force surpluses and because of the instability consequences of repudiations of the agreement to make payments by banks, central banks were invented as banking became ever more important in the economy.

Because banks had payment commitments to the holders of their liabilities, good bank management led to banks specializing in the financing of commerce, the movement of finished goods through the production process.

The financing of holdings of capital assets and of investment in early forms of capitalism and in modern colonial capitalisms took place outside the banking system. Households and partnerships financed capital asset ownership. Specialized financial institutions, such as mutual savings banks (a variant form of the savings and loan associations of ill repute) and insurance companies financed some longer term assets. As technology changed the need for longer term financing became more pronounced. The development of specialized financing organizations and markets, the stretching of the banks to finance capital assets and various state interventions to foster the financing of industry were responses to the changes in technology and in scale.
VARITIES OF FINANCIAL STRUCTURES.

We do not want to do genesis, we don't even want to do evolution. We want to examine the options the emerging economies of Eastern Europe have with respect to their financial structure.

One fundamental aspect of the economies that are emerging from Communism is that no significant private wealth exists, even though there are capital assets which are used in production and which at least potentially may earn profits. This is so because the capital assets of the economy - the power generating plants, the factories, the farms and housing - are not measured in the unit of account and liabilities, which are claims to the profit flows these capital assets are expected to earn, are not entered as assets in either household balance sheets or in the balance sheets of intermediaries which in turn have liabilities to households. As there is no history of profits earned that is really relevant to the emerging economies there is no way to generate such values.

Furthermore there is no simple way to create legitimate private claims on future cash flows which, because they are marketable, are priced and therefore are wealth. This is so because it is not possible to impute the creation of specific capital assets to some specific earlier exchange of...
money today for money tomorrow where the money today came from some identifiable class of individuals or financial institutions.

Financial structures of capitalist economies differ in the importance and strength of financial institutions and markets. Banks which are mainly restricted to short term financing of business and financing household positions in primary securities and housing will be dominant in economies with a strong market for primary debts and equities. This structure requires that there be many individually managed portfolios and that households are willing to invest directly in corporations. A market based financial system requires households to believe in the integrity of the corporate structure. They need to believe that the managements of corporations are operating as fiduciaries with respect to the stockholders: that enterprises are being operated in the interest of stockholders.

Some of the turbulence in Wall Street since the leveraged buy outs reflects a feeling that often business managements have been operating not as fiduciaries but in their own self interest.

In a simple structure we can conceptualize, banks are restricted to short term lending operations secured by goods in the production and distribution system. The cash to repay the banks will be forthcoming as these goods are sold. Such banks mainly lend to commerce rather than to industry. This restriction of bank assets guaranteed that cash flowed
from the production system to the banking system and that
the banking structure had to make new loans if the level of
activity was to be sustained. This structure meant that
banks did not participate in the financing of positions in
capital assets except as the production of capital
(investment) required financing. Households directly or in
partnerships owned the capital stock of the economy.

If a commercial banking structure survives as capital
assets become more expensive and as corporations become
dominant organizations, the financing of large scale
investments and expensive capital assets requires that an
investment banking community first structure the liabilities
of firms, then distribute the instruments and finally
provide for the trading of the resulting shares and bonds.
(Corporations are the business organization form that is
best suited for productions that require large scale, long
lived capital assets.) This capital market/commercial bank
structure, which is dominant in the United States and
Britain, is but one financial structure option. To work
well a large capital market is required.

The commercial bank-capital market structure initially
(historically) has households owning stocks and bonds of
individual companies. In United States over recent years
the significance of the private holder of corporate equities
and bonds of large companies has decreased significantly.
There has been a great democratization of the ownership of
wealth, even though only a small percentage really own a
significant amount of income earning wealth. Most households that own wealth own it in the form of interests in funds such as mutual funds, pension funds, money market funds, trust funds and insurance reserves and in turn these funds are the major holders of the liabilities of the largest companies.

As a result of the vast accumulations in these funds a new form of financial capitalism has emerged. The managers of such funds are most important in determining what form financing takes and the emphasis of operating firms as they contemplate financing either activities or asset holdings. The managers of these funds are mainly interested in what has been called total returns, which are the short term combination of returns as interest and dividends and the change in the value in the market of the securities in the managed portfolio. The various manias, from conglomerations to leveraged buy outs, that have swept American capitalism in the past years reflect the power of these funds. The 1990's, version of the capital market/commercial bank financial structure can be called money manager capitalism.16

15. Household wealth in the form of the accumulation of consumer goods and housing is ignored. The emphasis is upon the ownership of wealth in financial forms.

16. In a well known passage Keynes contrasted speculation and enterprise. He remarked that if the capital development of an economy is left to the activities of a casino, the capital development is not likely to be done well. The linkage between the seeming decline in the technical dynamism of the United States and the emergence of Money Manager capitalism is worthy of exploration.
Two alternatives to the capital market/commercial bank financial structure can be delineated. One alternative is a financial structure that emphasizes Universal Banks, banks which have corporate equities in their portfolios and which take a managerial interest in operating firms. The second emphasizes Public Holding Companies, which are public bodies that own equities and long-term debts of operating and financial companies and which take a managerial interest in the companies whose equities and debts they own. Both of these structures reflect a weakness, a thinness of capital markets.

In a Universal Bank financial structure equities of private firms are held in title or in trust by banks. Households own bank liabilities, which may have the characteristics of money or be deposit certificates which are not funds that are immediately available to finance household spending. If households own equities in large companies these equities are often controlled, as far as voting, for directors and the policing of management, by the banks.

17. The parallelism between universal banks and public holding companies is noted.

18. In the United States the reputation of private capital markets was adversely during by the great collapse of financial markets over the 1929-33 period. A public holding company, the Reconstruction Finance Corporation was an important part of the depression containing and expansion inducing mechanism. As recovery took place and as the New Deal's reforms made private capital markets once again acceptable the position of the Reconstruction Finance Corporation was sold off.
In the public holding company model the equities of operating companies, which are formally organized as if they were private companies, are held by a public "holding company". The public holding companies finance their position by borrowing from banks, the market and grants from the Treasury.

The 1990’s model of the capital market/commercial bank financial structure in the United States has a wide dispersion of claims to capital income – it may be called a peoples capitalism – but a large percent of the claimants to the income and the asset value of the liabilities of firms do not own any significant non-housing assets that are the direct liabilities of functioning economic units.

With the emerging dominance of the managed money funds in the United States there has been some convergence between the three models. This convergence is also reflected in the United States by a proliferation of government endorsements of private obligations.

THE OPTIONS

Because there is no significant private wealth in the economies emerging from Socialism, markets for financial instruments and the potential for market based financing is weak. The initial choice of a financial structure is constrained to emphasizing Universal Banks or Public Holding
Companies. Neither the Universal Bank nor the Public Holding Company should bar the way to the development of small-scale service and artisan industry. Special venture capital holding companies and banks should be part of the financial structure. Small scale and artisan industries will be a start on the direct ownership of wealth. Such industry will use commercial type bank financing in addition to the venture capital it needs.

Pension funds and private savings in mutual funds should be encouraged. The public social security system should be little more than a guarantee that the aged will not be in dire poverty so that private pensions develop. Social policy may therefore induce steps towards the money manager type of capital market relations.

But such steps will only be possible only as the public holding company or universal bank model succeeds in financing sufficient investment so that firms both large and small are profitable. Proven track records of operating firms being profitable are necessary for their assets, and therefore for their liabilities to be valuable.

If the aim is to create a peoples capitalism in which pension, life insurance and mutual investment funds emerge, then the transition from the inherited Socialism to a market economy may well be through the public holding company route rather than the Universal Bank. This is so because the Public Holding Company is viewed as a temporary holder of assets until such time as the markets become thick enough to
absorb their liabilities, whereas the Universal bank structure is viewed as being permanent.

Both the public holding company and the universal bank financing structures reflect the thinness of private capital markets in countries such as Germany and Italy where they are preeminent. The main problems of transiting from socialism to capitalism are the creation of manageable profit-seeking firms, the generation of private wealth holdings and the effective financing of investment. The simplest path is to first transform enterprises into corporations and create a system of public holding companies - both national, regional and local - which own the equity shares of these corporations. The holding company directs the subsidiary companies to operate so as to make profits. In the initial phase it will need to be recognized that in the absence of a history of meaningful prices initially even potentially profitable organizations will have losses.

The holding companies will acquire funds to finance investments of their subsidiary units by retaining earnings and by issuing bonds which pay attractive rates and which carry government guarantees. Banks may be authorized to take some tranches of these bonds, and banks will finance their position by issuing deposit certificates that are not immediately available cash. As workers acquire vested pension rights by reductions from their wages, the pension

19. This makes the holding company formally similar to the Sloan structure of General Motors, a management structure which was most successful.
funds will provide a market for the liabilities of the holding companies. Mutual investment funds need to be authorized on both national and provincial levels that will have portfolios of not only the debts of the public holding companies but also shares of private companies with profit records.

The public holding company is to be considered as a transitional device (the model is the previously mentioned Reconstruction Finance Corporation of Roosevelt's New Deal) but the transition can be expected to be rather long.

The assets of the public holding companies are the equity shares of enterprises. As particular enterprises begin to make profits their equity shares will acquire value. The public holding company should slowly sell out its positions in these profitable companies, transforming them into private companies. The pace of privatization is ruled by the rate at which enterprises begin to generate believable profit flows and the rate at which the market for equity assets grow as individuals and funds acquire the ability to accumulate wealth.

The public holding company route has two virtues as compared to the alternatives. It is flexible which means that it has the ability to adjust to changing market

20. In truth the Reconstruction Finance Corporation was put in place during Herbert Hoover's term, a term which virtually coincided with the great contraction of the world economy.
conditions and it makes for an orderly transition over a flexible time frame to a modern capitalist financial structure. Furthermore by allowing for local as well as national public holding companies it provides for a decentralization that may well be the key to success in an increasingly fragmented political structure.

The alternative is a system of competing Universal Banks, where the households own liabilities of the banks and the banks own liabilities (equities and debts) of companies. If the banks are publicly owned then the transfer of enterprise equities to these banks is formally equivalent to the placing of enterprise liabilities in the portfolios of public holding companies.

The virtue of the public holding companies is the decentralization of power. Equity and long term debt financing is separate from the short term financing.

CONCLUSION

The transition to a market economy requires the construction of a financial system. The simple fact of the matter is that there is no private wealth and there is no effective price level for capital assets in the countries emerging from the Stalinist epoch. The practical device of public holding companies is a way to operate the economy as
the information and private wealth required for a capitalist economy develop.

A question that hasn't been addressed is whether there is sufficient altruism and competence in the affected countries to operate public holding companies. We have to acknowledge that the countries that are now emerging from the Stalinist epoch have never been very successful either as economies or as democracies. If the future is to be different from the past - if Eastern Europe is to emerge from the morass of Communist rule and become a place in which a large proportion of households can obtain significant elements of capital assets and claims to capital income - with the achievement of this goal, or if the goal is still remote, then there must be a series of public holding companies that own the shares of the operating companies and which select the management and ensure that the companies operate to serve the interest of their location.

A personal point of view: I take it in the
function that the way private wealth is to be

Shed from private savings as well as the
development of membership by the holding companies
and perhaps the transformation of holding companies into
profit-driven enterprises to

Of course, I'm not sure that the
every piece of the
development by the holding companies...