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 rapid movement of history has replaced the initial aim of achieving socialist market economies by a goal of achieving a rapid transformation to a capitalist economy.

The transformation started even as there is no serious body of available literature on problems of the transition from a command or planned socialist economy to capitalism. What has been happening has been both rapid and helter-skelter: furthermore these changes are taking place in a political situation dominated by public impatience. However real results take time: an idea that 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

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 capitalist economies, whether conservative or social democratic, from economies based on Leninist - Stalinist principles: the salient fact being that market economies are financial systems by which the incomes that firms earn in production and distribution are transformed into personal incomes and personal wealth. In a capitalist economy basic economic units, households, have a net worth, they own wealth.

Furthermore the financial system not only transforms the value of the productive capacity of the economy into private wealth but it also plays a key part in the process by which investment takes place. In a modern economy the demand for investment outputs takes the form of an ability to spend money to obtain the complex and expensive plants and machineries needed for modern production. Money "now" is needed for such projects and the financial system is the mechanism by which investing firms obtain the money now in exchange for promises to pay money "later". The money "later" which enables the commitments undertaken in financing contracts to be fulfilled is to be obtained from the receipts that the project is expected to generate i.e. by the profits enterprises are expected to earn. It is important to note that the financial system of a capitalist economy links the past, the present and the future.
There are many different financial structures for capitalist economies in history, in existence and in our ability to invent. These variant financial systems have different impacts, not only upon the static efficiency of an economy but also upon its stability and its ability to grow. Furthermore the financial structure is a major determinant of the distribution of both income and power in the economy.

Therefore there are choices that need to be made, options that need to be considered by the former Socialist economies. In this paper some attributes of Capitalist financial systems are sketched so that the transformation to capitalism can be informed.

FINANCIAL SYSTEMS

Financial systems consist of institutions, such as commercial banks, investment banks, pension funds etc., instruments, such as common stocks, bonds, bank debts, deposits, etc. and markets, such as the stock and money markets. The various financial instruments are made and traded in markets. The details of the functioning of the stock and money markets depend upon the structure of financial institutions and instruments. In many of the important financial markets institutions rather than individual households are the principal players.

Financial commitments are owned by units in the economy and to these owning units they are claims to receive incomes
in the future. These commitments are first created in an exchange where money is paid today in exchange for particular claims to future incomes or cash flows. The cash flows, above what are needed to meet wage bills, tax bills and purchases from other units, which are available for the holders of financial instruments are conventionally called gross profits. As a result of commitments made in the past, the cash flows (gross profits) that are realized at any date are allocated among claimants as outstanding financial instruments state and to entries on the books of financial institutions.

These claims are accepted as legitimate in the society 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 privatization should be done
very carefully especially if the capital assets were created without initial private financing. Questions of how to create legitimate titles need to be addressed in the discussion of the transformation of Eastern Europe. In particular the legitimacy of granting titles to those who now occupy some productive capacity may be questionable.

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 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.3

CAPITALIST COMPLEXITY AND THE RELEVANCE OF ECONOMIC THEORY.

Because of these financial linkages in a capitalist economy between the past, the present and the future, simple linear models that abstract from money 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 when a theoretical structure where money and finance are ignored is used for policy making. Policy makers for the economies that are building market economies from so to speak scratch should take the advise 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. Such models indicate 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.

The surplus and finance.

In any economy where investment takes place - or where there is a court, an army, a priesthood or net production for the use of foreigners - the total of wages paid is greater than the wages paid in the production of the goods wage earners will buy. Put it simply wage workers producing
investment output or who serve the person of the Prince have to eat. As a result the price of the goods wage earners buy is greater than the labor costs of in producing these goods. This elementary relation indicates that there will be a financial 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 financial surplus which is forced by investment spending takes the form of profits. Two attributes of any capitalist economy are affected by its financial system: the allocation of the gross profits of the economy among claimants and the financing of spending in such a manner that the composition of demand generates a surplus. Profits, which are the flows that do or do not validate the financial instruments that are outstanding, are the lure that induces business men to invest and bankers to finance investment.

At the level of the individual unit and the particular deal the financing of investment takes place because a pro forma (a projection of revenues and costs, of cash flows) convinces the business man and the financier that the project will be profitable. The business man 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.

Assumptions about future economic conditions underlie these pro formas. When the construction and land development deals in Texas that undid Banks and Savings and Loans in that state were entered upon a not unusual assumption was that oil was heading towards ninety dollars a barrel. If that had happened land and property income and values would have made these failed institutions prosperous.

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 the aggregate economic conditions that were assumed in the pro formas of 1980 were being realized there would be no S&L debacle in 1990.

The financial system of a capitalist economy allocates the realized surplus to individual claimants - creating interest, dividends and retained earnings incomes. It also provides finance in excess of internally generated cash for investment, government deficits, export surpluses, and consumer spending.
The operations of the financial system finances demands which force surpluses out of the economy. Financed investment, financed government deficits, financed trade surpluses and financed consumer spending in excess of consumer incomes forces the surplus which takes the form of money flows. These money flows may or may not be large enough to validate claims to incomes that are legacies of past financing decisions.

I state these elementary truths in order to make the point that the transformation of socialist economy into a market economy involves the creation of a financial system. However the social and economic revolution in the once socialist economies is so profound and so wide that it is impossible to create reasonable or believable pro formas. There exists no rational basis by which to project future profits, for either existing enterprises or new projects, in the formerly Socialist economies. This implies that the financiers will be required to make great leaps of faith when they commit funds. In the light of the continuing problems with financing that reflected recent leaps of faith by banks and portfolio managers in Latin America, leveraged buy outs and real estate the requisite suspension of disbelief seems unlikely to happen. If the private financing channels are not available then the pricing of enterprises and the financing of investment will need to be based on considerations other than the numbers on pro
formas. Financing, whether domestic or foreign, in the absence of acceptable pro formas depends upon political considerations. The political considerations will either be domestic, which implies a continued socialization of the investment process or they will be foreign, which implies a dependency (colonial) status for the new emerging capitalisms.

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 and in adjusting 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 from particular enterprises, 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 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,\textsuperscript{12} are poor guides for understanding problems involved in the transformation of the hitherto socialist economies into capitalist economies: analyses which abstract from money and finance cannot be expected to lead to blueprints for the design of the financial institutions of the newly emerging market economies.

The critical problem that the transformation of Socialist economies into Capitalist economies needs to solve can be stated as: 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\textsuperscript{13} rather than the fulfillment of a plan.

The Heinz Company, the well known canner of pickles and purveyor of ketchup, used to have a slogan \textit{57 varieties} to describe the wide scope of the products it offered. I used
to say that there are as many varieties of capitalism as Heinz had of pickles. 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 small government 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 their liabilities.

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 the simple enumeration of assets had to be replaced with a value of assets. It is convenient to value assets in the same currency as the debts are stated.

In a modern capitalist economy such simple private ownership has been replaced with corporate ownership: the proximate owners of capital assets are now corporation. The simple ownership of the capital assets of the economy by individuals or even partnerships, as was true in olden days, has been replaced by corporations with 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 assets, generate. The essential time dimension aspect of capitalism arises, for unless the claims to cash are all contingent, depending 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 realized. The performance in the present may or may not validate commitments that were made in the past. This intertemporal nature of the financial relations of a capitalist economy explains why capitalist economies are likely not to behave in a nice equilibrium seeking way and why markets need to be regulated and controlled.

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 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 the two ultimates: the firms that are the proximate owners of capital and the household who are the ultimate owners of the wealth of the world.¹⁴

A major 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
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 capital assets was outside the banking system. Households and partnerships financed capital asset ownership. Specialized financial institutions, such as 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 of business 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.

**Varieties 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 there is no private wealth, even thought there are capital assets which are used in production. This is so because the capital assets of the economy - the power generating plants, the factories, the farms and the housing properties - are not measured in the unit of account and there are no liabilities, which are claims to the profit flows these capital assets are expected to earn, that are entered as assets on the balance sheets of households or of intermediaries, which in turn have liabilities to households. As there is no history that is really relevant to the emerging economy of profits earned, there is no way to generate such values.

Furthermore there is no simple way to create legitimate private claims on future cash flows which are marketable. 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.

Financial structures of capitalist economies differ in the importance and strength of institutions and markets.
Banks that 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 and derivative debts and equities. This structure requires that there be many individually managed portfolios and that households are willing to invest directly in corporations. Households have 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: they are operating the enterprise 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 financial structure we can conceptualize, banks are restricted to short term lending operations which are collateralized by goods in the production and distribution system. In this case the cash to repay the banks will be forthcoming as these goods are sold. In this model 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 as individuals or in partnerships directly owned the capital stock of the economy.

In a commercial banking structure the financing of large scale investments and expensive capital assets requires that an investment banking community first structure, distribute and then provide for the trading of shares and bonds of corporations, the business organization form that is best suited for productions that require large scale, long lived capital assets. Thus one financial structure option is the capital market/commercial bank structure. This still may be the Anglo American ideal.

The above structure has households owning stocks and bonds of individual companies. In United States today 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, mutual, pension, money market, trust, and insurance reserves. These funds are the major holder of the liabilities of the largest companies. As a result of the vast accumulations in these funds a new type of financial capitalism has emerged. The managers of such funds are mainly interested in what has
been called total returns, which are short term returns of dividends and the change in the values in the market of the securities. The various manias, from conglomerations to leveraged buy outs, that have swept capitalism in the past years have reflected the power of these funds. Let us call this 1990's version of the capital market/commercial bank financial structure money manager capitalism.

Two alternatives to the capital market/commercial bank financial structure can be delineated, One is the Universal Bank and the second is the Public Holding Company. In the Universal Bank structure equities of private firms are held in title or in trust by banks and households own bank liabilities, which may have the characteristics of money or be deposit certificates which are not immediately available. 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. 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 the markets for financial instruments and the potential for market based financing is weak in the eastern world. The initial choice of a financial structure will be predominantly either the Universal Bank or the Holding Company model. As small scale service and artisan industry develop a start will be made on simple direct ownership that uses commercial type bank financing. As pension funds and private savings in mutual funds grow steps may well be taken towards the money manager type of capital market relations. But this will be possible only as the public holding company or universal bank model succeeds in generating firms with proven track records as far as profits are concerned. If the aim is to create a peoples capitalism using pension,
life insurance and mutual investment funds, 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.

In Germany and Italy, countries where the universal bank and the public holding company are preeminent, capital markets are thin. This certainly is true of the former Socialist economies.

The need to create manageable firms and to finance investment are main elements of the problem of transiting from socialism to capitalism. The simplest step is to first transform all enterprises into corporations and create a system of public holding companies. The national and local governments are to own the equity shares of the holding companies. The subsidiary companies, who now have titles to specific capital assets, bank lines of credit and access to capital markets by way of the Public Holding company, are given directives to operate so as to make profits. Given the absence of cost structures, the obsolescence of assets and the inexperience in producing for markets many of the subsidiary firms will make losses.

The holding companies will finance the investments of their subsidiary units by issuing bonds, bonds that pay attractive rates and which carry government guarantees. The banks may be authorized to take some tranches of these bonds, and they will finance their position by issuing
deposit certificates that are not immediately available cash. The workers will acquire vested pension rights by reductions from their wages, these pension funds will also purchase the liabilities of the holding companies. Mutual investment funds will be authorized on both national and provincial levels that will have in their portfolios not only the debts of the public holding companies but which will also be authorized to buy shares of private companies with profit records as they are privatized by the holding companies or as they emerge de nova.

The public holding company is to be considered as a transitional device (the model is the Reconstruction Finance Corporation of Roosevelt's New Deal) but the transition will 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 serves two purposes. It is flexible which means that it has the ability to adjust to changing market 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 the decentralization that will be the key to success.

As an extension transnational public holding companies should not be ruled out.

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 are no meaningful prices 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 necessary information for a capitalist economy is developed.

A question that hasn't been addressed is whether there is sufficient altruism and competence in the affected countries to operate public holding companies. The countries that are now emerging from the Stalinist model have never been very successful economies.

1. It almost seems self evident that the so called planned economies were not in any serious sense planned. In serious planning the general interdependent relations in production
and consumption are considered. The obvious 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.

2. 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 the external financing. We also know that many cases can be cited where the presumption is unwarranted. A major problem in Capitalist economies is to develop devices by which the management of corporations operate in the interests of the stockholders, the owners.

3. In a Leninist-Stalinist socialism the link of today to the past is only in the capital assets available for use today and the link of today to the future is by way of gross investment and capital that is carried over.

4. The Savings and Loan crisis in the United States is a result of the gradual breakdown of the regulatory system over the post war period (1946-80) and a corrupting of the regulatory system in the 1980's. What is being called the 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 really does not matter - they know not what is happening and they therefor know not what to do.

5. It is well known that multidimensional non linear time dependent systems are almost certain to generate complex 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 W. Baumal and J Benhabib, "Chaos: Significance, Mechanism and Economic Application" Journal of Economic Literature, Winter 1989.

6. For a further explication of these relations see M. Kalecki Selected Essays on the Dynamics of the Capitalist

7 I wish to cite what I call William Janeway's first law, "Entrepreneurs lie." Minsky's corollary is "Banker's also lie."

8. This phrase consciously echoes Keynes.

9. As a result of the great collapse of the financial system between 1929 and 1933 believable pro formas were not forthcoming from private business for sufficient investment to generate a close approximation to full employment. 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 another way to generate acceptable pro-formas so that private financing of investment took place. The seeds of the 1990's S&L debacle, which rest upon government guarantees of private financing, were planted in the 1930's.


11. Joseph Schumpeter "The Theory of Economic Development" (Cambridge, Harvard University Press, 1936) is the classic English translation of a volume that had appeared in German some 30 years earlier.


13. 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", Minneapolis, The University of Minnesota Press, 1938) is the classic statement.

14. There are organizations such as Universities with their endowments who are artificial households.

15. Household wealth in the form of the accumulation of consumer goods and housing is ignored.