

THE CRASH OF '87 - WHAT DOES IT MEAN?

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The crash of 1987 furnishes prima-facie evidence that modern capitalist economies, with complex, sophisticated and ever evolving financial structures, are inherently endogenously unstable. Over the years since World War II economics has been dominated by doctrines that were set up to yield the conclusion that decentralized markets result in either a static or a growth equilibrium. The events of October 1987 have shown that eminent practitioners of this economic theory are as barren of insights into why financial crises occur as their predecessors in distinction were in 1929. They stand as the weavers and tailors stood after the little boy cried out "The Emperor is naked".

Monetarism and supply side economics are big intellectual and political losers. In general the neoclassical synthesis has been hurt, even though some of the new generation of practitioners are getting what they call Keynesian results out of the preference system, production function and maximizing behaviour structure of neoclassical theory. This success mainly is additional proof that well trained and ingenuous analysts are able to get the results they like by an apt selection of assumptions.

However, even the best of these neoclassical theorists do not expressly consider investment, its financing, the financing of capital asset holdings, and banking relations, which are alike in that they set up cash flows through time. Henceforth institutionalist and Keynesian concerns and analytical structures that lead to a recognition of the flaws in capitalism, due to various time dependent relations that are specific to capitalist finance, should carry more weight and the neoclassical theories, that have served as apologetics for capitalism, should carry less weight.

What happened on October 19 and 20 cannot be explained as normal, albeit not everyday, events by the neoclassical synthesis. It is a theorem of Post Keynesian theory that it is normal for conditions conducive to financial instability to develop in a capitalist economy. This is so because bankers, business men and portfolio managers react to profit opportunities by adjusting their asset and liability structures so that, over a period of time, payments on liabilities become more closely articulated to receipts from assets.

In a world characterized by uncertainty, in the sense of Keynes, Knight and De Finiti, successful functioning of a capitalist economy leads to changes in perceptions of the likelihood of outcomes and therefore in the bets that are made. The bets that firms make to finance their holdings of capital assets and their purchase of investment outputs are revealed by the structure of their liabilities. Bankers and managers of money place bets as they acquire the liabilities of businesses, households and governments and as they structure their own liabilities. Specifically successful functioning of a capitalist economy means that there is an increased acceptance of liability structures that pledge ever greater proportions of the expected cash flow from operations or assets to servicing liabilities.

Financial robustness exists when firms and households have little indebtedness and as a result bank portfolios are heavily into government debt: this situation ruled for about twenty years after World War II. History has shown financial robustness to be transitory. Analytically financial robustness leads to low short term financing rates and therefore it offers large payoffs to those who are willing to stretch the accepted bounds of liability structures by financing long positions with short liabilities. Financial robustness leads to liability experimentation and institutional innovation, whose effects cumulate over time, so that initially robust financial structures become fragile. Financial fragility leads

to conditions in which from time to time a substantial need to try to make position by selling out position arises. Financial fragility is a necessary condition for markets to perform in the manner we witnessed in mid October.

The necessity for intervention to thwart a destabilizing thrust and the power of such intervention were once again made evident in October. The Federal Reserve increased the reserve base of banks by some 2% in the immediate aftermath of the crisis. (Source: Robert M. Giordano *Financial Market Perspectives*, Goldman Sachs, December 1987) This was the fifth time the Federal Reserve acted as a lender of last resort in the 1980's. (The five are the Hunt silver affair in 1980, Drysdale and the Chase bank in 1982, Mexico in 1982, Continental Illinois in 1984, and the stock market collapse in 1987: this Goldman Sachs chronicle does not include the Penn-Square episode of 1982, which occurred simultaneously with the Mexican crisis). Each time the Federal Reserve reacted by substantially increasing the reserve base.

The critical and most interesting day for economic analysis was Tuesday October 20. As the Wall Street Journal described it, by noon of Tuesday the stock market was ready to close, for sell orders so outweighed buy orders that if orders to sell were fulfilled the market would be in a free fall.

In particular the specialist system on the floor of the exchange and the block trading (position taking activity) of the great street houses had ground to a halt. Bank financing was being withdrawn and the specialists and houses were unwilling to commit what was left of their equity to position taking in what they feared was a free fall market.

As this was taking place President Corrigan of the New York Federal Reserve Bank was in direct contact with both the banks and the houses. It would

be consistent with the responsibilities of the lender of last resort for the New York Federal Reserve Bank to have lent directly to the specialists and the block traders and to have guaranteed the banks and the affected Wall Street houses against further losses from taking positions. As the Wall Street Journal reported, after Corrigan intervened the market turned around. The day ended with a gain.

It is worth noting that in the aftermath of the crash, Fidelity Investments, which offers over 100 funds and which manages about \$80 billions, announced that it intends to increase its bank lines of credit so that a flood of orders to redeem its funds will not lead to a need to sell securities. The distress of October is inducing a financial innovation which makes the managers of money beholden to banks and changes mutual funds, which are now prepared to finance some of their holdings with bank debt.

We might characterize what we have now as *THE NEW CAPITALISM OF "MANAGED MONEY"*. Over the ages we can distinguish varieties of capitalism: commercial, industrial, financial, corporate, and the welfare state. In the past decade a new form of capitalism has emerged, which reflects the increase of the "clout", to use a Chicago word, of managed money. Pension funds, mutual funds, insurance companies, and bank administered trusts are now much more important than they were earlier in the capitalist epoch. This money is managed to obtain the largest total return, i.e. to maximize the sum of the cash flow, in the form of dividends and interest, and asset appreciation. Because of the weight of short term asset price movements in determining the total return, managed money is active money: managers pursue short term asset appreciations by actively trading their portfolio.

Keynes distinguished between the returns from enterprise and the returns from speculation; enterprise returns are dividends, interest and retained earnings

usefully invested, speculation returns are asset appreciation not due to retained earnings. Managed money conforms to Keynes's definition of speculation. We can recall and paraphrase Keynes's remark that if enterprise is a mere bubble on a sea of speculation the capital development of an economy is likely to be poorly done.

The growth of managed money brought into being institutions and usages (ways of doing business) in financial and other markets that facilitated (and made money off of) their operations. Multi billion and even multi million dollar funds deal in large blocks of shares. If these shares were sold or bought on the open market they would move the market. To prevent this large blocks are not bought or sold in the normal market manner; large blocks are bought and sold by the block trading desks of the major houses. These block traders buy for their own account and then either dribble their holdings out in the market or find some other body of managed money that wants to acquire these shares or bonds.

Over October 19 and 20, even as money managers were trying to sell securities, the block traders were both reluctant and increasingly unable to take positions. Furthermore because the losses of October 19 had compromised the equity of some position takers (these organizations mark their holdings to market) on October 20 banks began to withdraw credit from block traders as well as from floor specialists.

At this juncture the New York Federal Reserve Bank intervened. It's guarantees freed the flow of credit and got the block traders and specialists to once again take positions. The 1987 crisis was resolved in a manner analagous to the way the much studied British crises of the 19th century were resolved. The Central Bank intervened to assure that a market worked, not to protect an individual bank or some exposed speculators.

Economists and market participants should now appreciate that one reason why the fragile financial structure did not collapse between 1980 and 1987 is that the Federal Reserve, fulfilling its responsibilities as a lender of last resort, intervened five times to sustain institutions as diverse as the Hunts, the Chase Bank, lenders to Mexico, the depositors of huge sums in Continental Illinois, and the normal functioning of the stock exchanges. The Federal Reserve has demonstrated it can contain the dynamics that lead to chaotic financial markets and which would have strong immediate impacts upon income and employment: the Federal Reserve can sustain orderly conditions in financial and output markets.

The same history of the 1980's shows that the Federal Reserve cannot effectively determine the target level or trend of money or High Powered Money. The periodic threat of market instability forces the Federal Reserve to feed its liabilities, which become bank reserves, into the financial structure: the money supply is endogenously determined.

Lender of last resort responsibilities throws light on Volcker's tenure as Chairman of the Federal Reserve. He was more successful as a lender of last resort than as a controller of the money supply or of the economy. Because of the recurrent threat of financial crises the quantity of reserve money was endogenously determined by the need to maintain orderly conditions. The transitory success that was achieved in containing inflation in the 1980's was due more to wage constraint, resulting from the Administration's trade union bashing, tolerance of unemployment, and accepting of imports, than to money supply constraint.

"Will the events of October herald the onset of another Great Depression?" is a recurrent question. The first thing to remember is that the Great Collapse took 40 months. It started with the stock market crash of October 1929 and ended as

Roosevelt was being inaugurated in March 1933. Much took place after 1929 that compounded the initial downward destabilization.

There is one great difference between the 1930's and the 1980's that has to be emphasised. Today the Federal Government is some 25% of GNP. In 1929 government was about 3% of GNP. There is a greatly simplified formula for profits, usually identified with Kalecki, that reads

$$\text{profits} = \text{investment} + \text{the government deficit.}$$

If investment is 16% of GNP there is no way the deficit of a 3% government can offset the effect upon profits of a sharp fall in investment. If government is 25% of GNP then a fall in investment can be offset or even more than offset by the automatic deficit and some rather slight adjustments in tax and spending programs. Profits collapsed in 1929-33, they cannot do so with today's structure of aggregate demand. I see no way a big government capitalism can repeat the collapse of 1929-33.

In the 1929-33 contraction the stock market indices eventually fell to some 15% of their prior peak. One reason for this was the drastic decline in the net and gross profits of business over 1929-33. The decline in gross profits greatly diminished the ability of business to validate debts, which adversely affected banks and other financial institutions. Today, through its deficits, big government sustains profits when investment declines

We are in Chicago, the Home of the Cubs, the site of the Henry Horner housing project, and historically a center of cynical and tough minded thinking. We should be true to our hosts and recognize that the real welfare queens of late 20th century capitalism, the true beneficiaries of government deficits, are not recipients of AFDC but profit, dividend, and interest receivers, whose incomes are sustained during recessions by government deficits.

The Kalecki equation opens up to
 $\text{profits} = \text{investment} + \text{the government deficit} - \text{the foreign trade deficit}.$

The great turn around in the United States trade picture during the Reagan years resulted in a drain of profits from the United States, mainly to Japan and Germany. In the first part of 1988 a recessionary malaise is likely to spread over the economy, triggered by but not caused by the stock market crash. This will cut United States imports of manufactured goods and thus the foreign trade deficit. This will adversely affect Japan and Germany.

It will be up to Japan and Germany to maintain their prosperity by expansionary fiscal and monetary policies if the recession is to be mild and short. Whether or not there is a recession in 1988 that is prolonged and severe depends to a large extent upon whether Japan and Germany can maintain their prosperity without the help of a massive United States trade deficit. If they cannot maintain their markets open to imports even as they maintain domestic prosperity then a new round of beggar my neighbor policies are possible. If this happens the recession will be prolonged.

The events of October and since constitute prima facie evidence that the price of non-interventionist, unregulated and small government capitalism is so high that it is a non starter as a possible economic structure. But this does not mean that the 1980 or 1987 structure of big government interventionist capitalism is the best we can do. We now appreciate that a structure of regulation and intervention once in place runs out of steam as time goes by and business and households learn how to avoid, evade and accomodate to the structure. We now understand that programs that are not modified as avoidance, evasion, and accomodation take place are likely to become counterproductive: to lead to results that are not initially envisaged.

Thus the job of managing capitalism requires constant institutional reform, especially if the aim is to promote the development of resources, the enhancement of opportunity and the advancement of equality. Understanding of how in place economic institutions work needs to be combined with constant institutional innovation if we are to achieve a closer approximation, than we have hitherto attained, to what is, after all, the universal policy objective: A humane society.

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