Financial Crisis and the Evolution of Capitalism

The Crash of '87 - What Does It Mean?

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A. Introduction

Footnote 1: Ultimately monetarism evolved under the influence of Lucas and the doctrines of rational expectations; see the essay collected in Lucas, R.,

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with the proposition that the economy fully expanded and carried out policies of monetary constraint would lead to virtually certain depression. Those scale unemployment and financial turmoil were not to result.

Supply-side economics

Footnote 3: Supply-side economics

Like hot tamales would soon be in production in what became

inflation, evidence that modern complex, sophisticated and ever more by their very nature he years since World War II y doctrines that were set up centralized markets result in equilibrium. Comments on the own that eminent dard economic theory are as financial crises occur as their re in 1929. They stand as the little boy cried out economics are big

Footnote 4: In general the
neoclassical synthesis (the tec
dominant economic theory) has b
the younger economists are gat
results out of the preference s
and maximizing behavior struc
This success demonstrates that
analysts are able to get the re
selection of assumptions.

However, even the best of
do not expressly consider inves
financing of capital asset hold
which are alike in that they se

4. Exercises such as theory

Hahn Jr.

which seems to have det to
be an approach extermin
in which we have
which tends to central bank
an interest should be
much less acceptable. Rin-
L. Hahn Jr.

3/ The neo-classical synthesis
endorses the microeconomic
models that relate microeconomic
behavior to the behavior
which maximizing household or
profit maximizing firms. These
models can be derived
from earlier work by
Hahn Jr.

M. D. Hahn Jr.

which make evident to
labor market equilibrium and
determinant of
economic equilibrium.

The F. A. Hayek
as called Keynesian results on

portfc
their
period

becoming available from neo-classical
synthesis set-ups see
M. D. Hahn Jr.
In a world characterised by uncertainty and changing economic conditions, a key issue is how to manage financial liabilities. Keynes, Knight, and other economists have argued that the likelihood of alternative asset outputs are revealed by the structure of business liabilities. Bankers and managers of businesses develop strategies to manage these liabilities, often taking on additional risk to ensure stability.

Herman P. Young

Robert Bridom
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.

B. Lender of last resort

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, Drexel 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 

(asking taking activity) of
ground to a halt. Bank
and the specialists and houses
was left of their equity to
'scared was a free fall market.

President Corrigan of the New
in direct contact with both
would be consistent with the
of last resort for the New
lent directly to the
and to have guaranteed the
hedges against further
the Wall Street Journal
said the market turned

aftermath of the crash,
over 100 funds and which
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
Well the State
Examination, I had to be
It was it was the thing
yet achieved I am presently
-untold burden
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.

C. Managed money capitalism

We might characterize what we have seen 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 speculations: enterprise returns are dividends, interest and retained earnings that are usefully invested whereas speculation returns are asset appreciation not due to retained earnings. Managed money conforms to Keynes's definition of speculation, for the
appreciation or depreciation of asset prices can dominate in the determination of total return. We can recall and paraphrase Keynes' remark that if enterprise is a mere bubble on a sea of speculation the capital development of an economy brought into being for doing business in facilitated (and made money) a billion and even multi-giga blocks of shares. If or bought on the open market, appreciably change the looks are not bought or sold; mega blocks are first bought by desks of the major financial houses for their own account (take their holdings out in tidy of managed money that bonds.] Block traders were also who wish to take on positions in as money managers were 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.

Reserve

York Federal Reserve Bank

To control the flow of credit and

specialists to once again take

so resolved in a manner

studied British crises of the

The Central Bank intervened to

not to protect an individual

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participants should now

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tween 1980 and 1987 is that the

to responsibilities as a lender

least five times to sustain

c Hunt's, the Chase Bank,

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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.

...ibilities throw light on
the Federal Reserve. He was
not resort than as a
of the economy. Because
sial crises the quantity of
termined by the need to
a transitory success that
ation in the 1930's was due
ng from the Administration's
employment, and
y supply constraint.

herald the onset of another
that is often asked. The
the Great Collapse took 40
market crash of October
ing 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 1960's that has to be emphasized. 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

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

There is no way the deficit of a fact upon profits of a sharp ant is 25% of GNP then a fall even more than offset, by deficit that a decline brings adjustments in tax and apsed in 1929-33, they ure of aggregate demand. 

Laissez faire can not repeat the stock market indices

air prior peak. One reason in the net and gross

The decline in gross lity of business to teetered banks and other rough its deficit, big

ultimately profits when investment declines. The true beneficiaries of government deficits, are not recipients of Aid to Families with Dependent Children but profit, dividend, and interest receivers, whose incomes are sustained during recessions by government deficits.
F. International effects

The Kalecki equation opens up to

profits - investment + the government deficit - 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 1988 a
recessionary wave 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 global 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 open
their markets to increased 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.

G. Conclusion
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 1930 or 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 businesses try to evade and accommodate to programs that are not productive to lead to results. Capitalism requires constant recognition of the enhancement of equality. Understanding solutions work needs to be national innovation if we are to learn, than we have hitherto, the universal policy is to be a vehicle.