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FINANCIAL CRISES AND THE

EVOLUTION OF CAPITALISM:

THE CRASH OF '87. - WHAT DOES IT MEAN?

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A. Introduction

The world wide crash of financial markets on October 19 and 20, 1987 furnishes prima-facie evidence that modern capitalist economies, which are characterized by complex, sophisticated and ever-evolving financial structures, are by their very nature endogenously unstable. The crash and its aftermath also show that the structures of intervention and control that emerged over the decades since the Great Depression of the 1930's are able to contain the endogenous processes that in earlier times brought on great and serious depressions. As a result of the successful containment of instability, the evolution of capitalism in the main capitalist economies has been dominated by the result of government and market adjustments to isolated or contained crises that take place within an on-the-whole adequately performing system, rather than by market participants and government reactions to overriding crises and failed performance. One need but note that Thatcherism survived a full term of deindustrialization and unconscionable unemployment, mainly because welfare state transfers sustained the Andy Capp's of Britain at a tolerable standard, to recognize that the evolutionary dynamics of capitalism has changed.

In earlier times the stock market crash of October, 1987 combined with the third-world debt crisis, the imbalances in international trade, and the virtual bankruptcy of savings and loan institutions and their deposit insurance organization that characterize 1988 would have been more than enough to bring about a serious recession.[1] In 1988, even as serious financial disruptions take place, unemployment rates decline and corporate gross profits are unscathed. Capitalisms that successfully sustain incomes and contain crises are different than

capitalisms that are subject to serious depressions, especially in how they change through time.

Financial crises still occur. However modern capitalisms, characterized by governments that are a big portion of Gross National Product and central banking that is active and interventionist, have the ability to contain the effects of crises upon income, employment, profits and prices. This means that the evolution of capitalism is not now dominated by private and public responses to traumatic breakdowns but is the result of the adaptive behavior of markets and individuals in the context of interventions, by governments and central banks that, in a broad sense, are successful (although adverse "side effects" of the interventions do occur). Trauma, such as that of October 19 and 20, 1987, show the fragility of modern financial capitalism, the subsequent behavior of the world economy illustrates the resiliance of today's capitalism.

Over the years, since World War II, economics has been dominated by doctrines that were formulated to yield the conclusion that decentralized markets result in either a static or a growth equilibrium.[2] Comments in the press on the events of October, 1987 showed that eminent practitioners of today's standard economic theory are as barren of insights into why financial crises occur as their predecessors in distinction were in 1929. Purveyers of the conventional wisdom 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, for in these views, largely based upon an extreme and unwarranted interpretation of the substance of the aforementioned general equilibrium theory, a virtual breakdown of the financial system, such as occurred on October 19 and 20, is not supposed to happen. In general, the neoclassical synthesis (the technical

label for today's dominant economic theory) which in its modern guise reduces all economic behavior to the result of maximizing behavior by individuals has been hurt. This is so even though some economists are getting what they call Keynesian results out of the preference system, production function and maximizing behavior structure of neoclassical theory.[3] However, even the best of these neoclassical theorists do not expressly consider investment, its financing, the financing of capital asset holdings, and banking relations, i.e., they do not consider the economy as a structure that sets up cash flows through time.

The behavior of the economy since the late 1960's points to the need to economic theory to emphasize the intertemporal relations that mainly center around investment and finance. The economic theory that goes by the label post-Keynesian, which holds that an understanding of the behavior of a capitalist economy requires that financial considerations be fully integrated into the explanation of the path of the system through calendar time and which also holds that financial instability is a normal evolutionary outcome of periods of financial and economic tranquility, seems to be validated by the behavior of the economy.[4] Henceforth institutionalist and Keynesian concerns, as well as 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.

B. Cash Flows.

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 this construct the income, employment and production system generates cash flows and a portion of these cash flows are precommitted to the validation of various liabilities.

In a world characterized by uncertainty, in the sense of Keynes and Knight,[5] successful functioning of a capitalist economy leads to changes in perceptions of the likelihood of alternative 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 that was witnessed in mid-October.

C. 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.[6] 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, Drysedale 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 on 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.[7] 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 (although a deviation from conventional Federal Reserve behavior) 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 observing that by the actions of October 20 the domain of responsibility of the Federal Reserve was extended to include the prevention of a free fall in the prices of common stocks and other financial instruments. The prevention of a full-fledged debt deflation seems to require that the domain of responsibility of the Federal Reserve be continuously expanded.

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.

D. Forms of capitalism.

We might characterize the crisis of October 19 and 20 as the first financial crisis of THE NEW CAPITALISM OF "MANAGED MONEY." Although any neat stages and ages view of economic evolution should be taken with the proverbial grain of salt,

capitalism is such a changeable system that it is useful to think of varieties of capitalism as differentiated by the forms of organization and financing. We could well think of there being as many varieties of capitalism as Heinz had of pickles.

In particular we can distinguish forms such as commercial, industrial, financial, managerial, welfare state and managerial capitalism, recognizing that any real world capitalism will be a combination of these types. Because of space limitations we will consider only two forms: the managerial - welfare state capitalism of the post-war era and the newer managed money capitalism.

After World War II a combination of managerial and welfare state capitalism was dominant in the United States, Western Europe, and the other advanced capitalist economies. Managerial capitalism can be defined as a form of corporate capitalism in which industry, transportation and trade are largely dominated by firms that are characterized by hierarchical management styles where the management is drawn from self-perpetuating professional bureaucracies that are committed to technical progress and industrial "statesmanship": these managements exercise constraint in their prequisites and income and are not largely beholden to financial market organizations. The stockholders are widely dispersed and largely individuals - the widows and orphans that the Bell System used as a protective shield - who are largely satisfied with modest but steadily growing returns. As long as returns are steady, management is largely independent of stockholder influence and shows only minor concern about the course of the price of its stock.

In this post-war model, corporate capitalism recognized the legitimacy of the New Deal reforms (transfer payments, trade unions), even as the New Dealers backed off from the interventions, as envisaged in the prospective third New Deal of the Temporary National Economic Commission, that would have forced

competitive market conditions upon business. In the United States the post- war consensus was largely the work of the Committee for Economic Development, a group of liberal business men. The model guiding economic policy was of firms which operated in the absence of strong banker constraints and which possess market power but which used their market power with discretion. Furthermore firms shared the benefits of market power with their workers: labor was not to be sweated.

This paternalistic industrial arrangement took place in the context of a welfare state, which consisted mainly of a system of transfer payments, and Keynesian fiscal policies. This combination assured the economy against any large shortfall of aggregate demand and of business profits. The very success of this managerial - welfare state capitalism assured that it would run into difficulties, for the stabilization of profits against large downside deviations meant that the debt-carrying capacity of firms increased. Bankers and firms were sure to experiment with increasing debt and the "market " rewarded those who understood that the interventionist economy put a floor to the downside risks on aggregate profit flows.

E. Money Manager Capitalism.

In the past decades, as a response to the successes of managerial - welfare state capitalism, a new form of capitalism has emerged which reflects the increase in the "clout" 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 by professional money managers who aim to obtain the largest short-run total return of their portfolio, i.e,. to maximize the combination of short-term cash flows, 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 that are usefully invested whereas speculative returns are asset appreciations that are 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 Keynes's remark to the effect that if enterprise is a mere bubble on a sea of speculation the capital development of an economy is likely to be poorly done. Money manager capitalism emphasizes the value (price and positive changes in price) of financial assets and in particular ordinary shares. Money managers press the management of firms to act so as to sustain the market value of shares. This usually implies increasing indebtedness without any obvious increase in profit flows except if it is possible to exploit market power or sweat labor. Money manager capitalism implies that the Committee on Economic Development consensus breaks down: in particular firms are no longer managed on the basis of a longer view that entails investments in innovation, research and staff development.

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) the operations of the money managers. Multi-billion and even multi-million dollar funds deal in large blocks of shares. If these blocks of shares were sold or bought on the open market, they would move the market, appreciably changing their price. To prevent this, large blocks are not bought or sold in the

normal market manner; large blocks are first bought and then sold by the block trading desks of the major houses. These block traders buy for their own account (take a position) 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. (Block traders will also shop for stock for clients. Block trading facilitates the merger and hostile takeovers that have become a conspicuous part of the economics of managed money capitalism.

The growth of the funds (pension, mutual, bank administered personal trusts, and insurance) were a result of the absence of a major depression during the years since World War II. (Pension funds are part of the welfare state apparatus.) During the debt-deflation phase of a great depression, asset values are written down even further than income and employment declines: the surviving mutual and other funds would be those that appreciated the wisdom of portfolio prudence. Those whose portfolios were heavily weighted with liabilities of strong financial institutions would do better than those whose portfolios were heavily weighted with financial market assets. Great depressions induced portfolio conservatism, what Keynes called a shift to liquidity preference and what was called a shift to quality in the aftermath of October 19 and 20.

The viability of money manager Capitalism depends upon not having a serious depression: the continued absence of a serious depression fosters experimentation with portfolio managing techniques that increases the likelihood of system threatening crises, i.e., increases the likelihood of depressions. There is a basic contradiction in money manager capitalism, which makes continued success ever more dependent upon an apt structure of supportive government interventions. Money manager capitalism rests upon the power of Government to prevent a sharp decline in aggregate business profits.

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 at the end of every business day) on October 20 banks began to withdraw credit from block traders as well as from floor specialists.

F. Intervention by the Federal Reserve

At this juncture the New York Federal Reserve Bank intervened. Its guarantee 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 analogous 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 at least 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.

G. The Impact of Government

"Will the events of October herald the onset of another Great Depression?" is a question that is often asked. 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.

One great difference between the 1930's and the 1980's 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,[8] that reads

profits = investment + 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 increase in the deficit that a decline in income brings about and by 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. A big government capitalism can not 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. The true beneficiaries of government deficits are profit, dividend, and interest receivers, whose incomes are sustained during recessions by government deficits. Money manager capitalism is viable only to the extent that potential government deficits assure that profits will not collapse as they did in the 1930's.

H. International Effects

The Kalecki profit equation opens up to

profits = investment + the government deficit
- the foreign trade deficit.

The great turnaround in the United States trade picture during the Reagan years, largely a result of the short-sighted monetarist anti-inflationary policies of the early 1980's, resulted in a drain of profits from the United States, mainly to Japan and Germany. The result was a great growth in the holdings of United States

based-assets by the rest of the world: primarily Western Europe and Japan but also the newly-industrialized export-based economies of the Pacific basin. The United States' trade deficit and the continued growth of the United States' international indebtedness are not viable longer run situations. International economic adjustments will have to shift a larger part of the responsibility for maintaining global business profits to the countries that have recently accumulated international assets. This means that Japan and Western Europe, as well as the export platforms of Asia, will have to become in the aggregate net importers of goods and services. It is obvious that there will have to have great internal adjustments: economies that have been dependent upon exports will have to become dependent upon domestic consumption demand.

Japan, Germany and the other rich countries whose prosperity has been export driven will have to maintain their prosperity by domestic expansionary fiscal and monetary policies if global prosperity is to be sustained. Whether or not global prosperity is maintained 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 prosperity by domestic policies that abet their evolution into high-consumption, low-savings economies, then a new round of begger my neighbor policies are possible.

Money managers seek profits by international portfolio diversification and are sensitive to exchange rate fluctuations; positions are taken on the basis of exchange rate expectations. Money manager capitalism is hospitable to financial innovations such as the globalization and securitization of finance and to the growth of financing through markets relative to financing through institutions.[9]

I. 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 1980 or 1987 structure of big government interventionist capitalism is in any way a best. It is now evident that a structure of regulation and intervention once in place may lose its power as time goes by and business and households learn how to avoid, evade and accommodate to the structure. Avoidance, evasion and accommodation are words that summerize the process of economic evolution in capitalist economies that do not experience the trauma of severe and long-lasting depressions. Policies and programs that are not modified as avoidance, evasion, and accommodation take place are likely to become counterproductive: to lead to results that were not initially envisaged.

Managerial - welfare state capitalism gave the main capitalist countries an unprecedented period of success. The economic growth and the wide distribution of the benefits of economic growth that characterized the first two or so decades after World War II were clearly without precedent. However this success planted the seeds of a transformation in the mode of functioning of the economy in that the asset appreciation and cumulated savings that successful managerial - welfare state capitalism gave rise to large blocks of money and institutions to manage such money. The objectives of money managers are different than those of the management of the non-financial businesses that were the dominant institutional form under managerial capitalism.

The result is a fragile financial structure that, as was shown on October 19 and 20, may require intervention on a massive scale to prevent the collapse of asset

values. It is clear that apt government intervention is even more important if a semblance of successful functioning for money market capitalism is to be sustained than it was for managerial capitalism. Furthermore, it is more difficult to determine what constitutes apt intervention for this new and more complex form of capitalism. We can expect each crisis to be met by some *ad hoc* intervention which will in part reflect the inability of those who make policy to appreciate that once again capitalism has changed.

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