

Why 1987 is not 1929

Hyman P. Minsky

Business profits are the main driving force of any type of capitalist economy. In our modern big government capitalist economy the Stock Market is not as closely linked to the determination of business profits as it was in the small government capitalism of 1929-33. The extremely volatile stock market of 1987 is likely to usher in a recession, but unless it is compounded by utterly foolish policies, it will not trigger a depression.

The economy in 1929 was a small government capitalism. In such an economy business profits are, as a first approximation, determined by investment. We now have a big government capitalism and profits are, again as a first approximation, jointly determined by investment and the government deficit.

The great decline of stock prices over 1929-33 was paralleled by a like collapse in the prices of capital assets (factories and machinery), farm land, and housing. It became far cheaper to buy a factory from the stock of idle factories, a house from the stock of empty houses etc. than to order a new one built. This led to the collapse of investment and with investment profits.

In 1987 the sharp fall in stock prices is likely to lower sales of big ticket consumption goods and the prices of capital goods, houses etc.. A first reaction by firms will be to lower planned investment. A recession or a growth recession and a fall in profits will follow. But in our big government economy a decline in incomes from what had been expected automatically increases the deficit. This assures that profits will not collapse and the fall in the prices of capital goods etc. will be contained.

It is worth emphasizing that in the serious recessions of 1974-75 and 1981-82 profits were actually higher in the quarter with the highest unemployment rate than they had been a year earlier. These deep recessions of 1974-75 and 1981-82 are models of how stabilization policies work. They also furnish an answer to the question "What do successful stabilization policy stabilize?". The answer is "Profits".

In spite of the great increase in the role of government in stabilizing the economy, what happens on Wall Street, of which the Stock Market is a major part, has a major impact in determining whether our economy progresses, stagnates or declines. The activities in financial markets can mainly promote enterprise, defined as the placing of money in an effort to achieve a dependable flow of income from productive economic activity, or speculation, defined as the placing of money in the anticipation of achieving, gains from an appreciation of the market valuation of assets.

Keynes put it well when he noted that "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

Financial markets during the 1980's have been dominated by the seeking of gains by big players from changing asset valuations, mainly, though not exclusively, by way of mergers, leveraged buy outs, and take overs. In turn mass investments, either through direct stock ownership or by way of pension and investment trusts, were driven to achieve a maximum short term total return, i.e. to seek stock appreciation.

An economy will progress when financial resources are applied to the creation of better products and production techniques. This means that management does not aim solely to achieve the highest market valuation of its shares: management aims to achieve a steady and growing flow of profits from secure markets. Academics love to prove that the two objectives should lead to the same outcome. But in the world where management and their bankers must choose from a variety of liability structures it is often true that a highly indebted liability structure leads to a greater total valuation of a company than a lower indebtedness ratio. But such a liability structure, which is imposed by speculators who seek gains from revaluing

assets, often inhibits the financing of projects with longer gestation periods: the shortening of business horizons that is imposed by speculators puts a damper on enterprise.

In industry after industry the resource development strategy of firms has to play a secondary role to the market valuation game. A unwanted side effect of the dominance of the valuation game on Wall Street has been stagnating industries and a decline in technical leadership,

In the type of capitalism we now have, which is of course mainly the legacy of the reforms of the 1930's and the subsequent growth of government spending as a ratio to GNP, Wall Street and the stock market exist and matter, but they don't matter as much as they did when prior small government capitalisms ruled.

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Suggested title "Wall Street Exists and Matters"

The theme that Newsday has adopted is Does The Stock
Market Drive the Economy? The answer I would give is that
Wall Street is a powerful influence upon the economy, but it
in no way drives the beast, profits drive capitalist
economies. However wall street allocates claims to profits
and the new investment that occurs drives profits.

Before Monday's shake out we had a burst of refinancing
and restructuring that led to a much more heavily indebted
corporate structure than was compatible with the need for
progress. We still haven't housebroken the corporate form
of organization.