

## PART II

### THE INTERNATIONAL FINANCIAL SYSTEM

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# THE MACROECONOMIC SAFETY NET: DOES IT NEED TO BE IMPROVED?

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## INTRODUCTION

Although every economist pays lip service to Heraclitus' remark that "Nothing endures but change" or as Shelley put it "Man's yesterday may ne'er be like his morrow," economic regulators and intervenors, and the economists who examine regulation and intervention, almost always assume that the behavior of economic units will not change to take advantage of opportunities for profit or gain created by regulations and interventions. In truth behavior does adapt. Such changed behavior will affect the efficacy of the in-place system of regulation and intervention: The impact of adaptation will generally be adverse.

In time the ability to achieve an original set of objectives by means of an unchanged inherited set of regulations and interventions diminishes. As a result the situation that the structure of regulations and interventions was created to correct is likely to reappear, perhaps in a new guise. Thus a macroeconomic safety net, whose main purpose is to prevent serious recessions or depressions, is likely to be effective for a run of years and then lose its effectiveness; constant

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vigilance and revision of the mechanisms of the safety net are the prices of continued success.

Adaptation and evolution that undermines the efficacy of any unchanging set of regulations and interventions are especially evident in financial markets. No one knowledgeable about how money markets and banking organizations have changed will deny that the effect of central bank operations (monetary policy actions) on the behavior of the economy are much different in 1988 than they were in 1958 or 1948. An era of evolution in response to market opportunities has combined with technical changes in communication, data processing, and capacity to compute to throw into doubt many of the precepts that have guided monetary and fiscal policy and analysis over the past fifty years (Minsky 1982).

It is much too much to expect that banking and financial regulations and interventions that were put in place more than fifty years ago in an effort to contain instability do not need to be reviewed. As Henry Simons (1948, p. 172) noted:

Banking is a pervasive phenomenon, not something to be dealt with merely by legislation directed at what we call banks. The experience with the control of note issue is likely to be repeated in the future: many expedients for controlling similar practices may prove ineffective and disappointing because of the reappearance of prohibited practices in new and unprohibited forms. It seems impossible to predict what forms the evasion might take or to see how particular prohibitions might be made more than nominally effective.

Whenever innovations in regulation and intervention take place, the behavior of units changes. This can be interpreted as a learning process, in which it takes time for units to discover their best behavior in the new environment. Much of what transpires that attenuates the effectiveness of regulations and interventions occurs because units learn, but regulators and intervenors do not. This model of smart agents and stupid regulators has some descriptive value for the current issues of de- and re-regulation in financial markets. It also indicates that the macroeconomic safety nets need to have the ability to adapt built into their structure.

For macroeconomic regulation and intervention to be successful it needs to be grounded in an understanding of:

1. the principles that guide the behavior of units,
2. how the instability that regulation and intervention is to contain is brought into being,
3. how regulations and interventions create opportunities for gain, and
4. how changed behavior affects the efficacy of the regulatory intervention regime.

The authorities who regulate and intervene need to be aware that economic evolution is in part an adaptation to regulation and intervention.

## **THE PRIORS**

Priors, or theoretical presuppositions, underlie every argument on economic policy and the role of economic institutions in determining system behavior. All too often in economic argumentation the priors are an unspoken assumption of the validity of the Smithian view that if economic units pursue their own ends they are guided, as if by an invisible hand, to generate a result that is a social optimum. What follows is not in this tradition. The prior is the financial version of Post Keynesian economics. This theory argues that the endogenous processes of the economy will from time to time generate conditions conducive to financial crises and deep depressions. Whereas, within the Smithian tradition, intervention and regulation can only cause mischief, within the financial instability version of Post Keynesian economics apt intervention is constructive (for a statement of the financial version of post-Keynesian economics, see Minsky 1975, 1986).

## **THE COMPONENTS OF THE DOMESTIC MACROECONOMIC SAFETY NET**

The macroeconomic safety net consists of measures that will override the endogenous dynamics of the economy whenever those dynamics threaten to generate unacceptable values of specified variables; the macroeconomic safety net is simply another term for stabilization policy. If the regulations and interventions have been built into relations determining system behavior, such as the spending programs and taxes of government, they may be characterized as rules and be considered automatic. On the other hand, the regulatory and intervention system may require some authority or agency to draw inferences from system behavior and respond; in this case there is an authority (the Federal Reserve Board, the Congress) that has discretionary powers.

An appreciation of economic evolution leads to the view that the authorities need to understand the import of changes in the institutional structures and to react to novel situations. This means that economic policy cannot be reduced to a set of invariant rules. The authorities must interpret what happens and, therefore, they must possess the power to discriminate.

Monetary and fiscal policies are the macroeconomic interventions and regulations in an advanced capitalist economy. Although the power of trade unions and the structure of industries affect the efficacy of monetary and fiscal policies, the rules and institutional arrangements that determine these structures will not be considered here as part of the macroeconomic safety net.

Stripped to the bare bones, the macroeconomic safety net aims to prevent a disastrous drop in one or both of

1. the total of business profits or
2. the market price of capital and financial assets in the unit of account (for a rationalization of the use of profits as the policy objective, see Minsky 1986a).

Note that if (1) occurs then in a capitalist country with a small government, (2) is sure to happen.

To sustain business profits, fiscal policy—i.e., government taxing and spending—needs to be so arranged that profit-sustaining deficits quickly appear whenever private investment tends to fall. To the extent that the budget automatically generates a deficit when income declines, profits are automatically stabilized. But if the automatic deficit is insufficient to sustain profits then, in the environment that has ruled since World War II, Congress and the administration are expected to quickly take discretionary actions that will achieve a sufficient deficit to sustain profits.

The link between monetary policy and profits is not as direct as that of fiscal policy. Nevertheless, the rules of contracyclical monetary policy aim to achieve aggregate demand objectives which can be translated into efforts to sustain profits. The impact of monetary policy has typically been strongest and most straightforward on construction, a component of investment and, therefore, a determinant of profits.

In addition to the safety net under aggregate profits, a financial safety net, which consists of the central bank and other governmental endorsing and insuring agencies acting as lenders of last resort, prevents a massive fall in asset values relative to current output prices. This lender of last-resort function reflects a subtextual view that the relative price level of capital assets and current output is the principal determinant of major swings in investment and, therefore, in profits and the ratio of actual to full employment.

An era of turbulence began in 1966, when the credit crunch signalled the end of the tranquil era that had ruled from the end of World War II, and has continued until now. During these now more than twenty years, the two components of the macroeconomic safety net—the stabilization of profits and lender of last-resort interventions—working in tandem have succeeded and are still succeeding in containing and reversing threatened financial crises and depressions. The question of improving the macroeconomic safety net implicitly reflects fears that synchronized interventions that were successful in the past will not be successful in the future.

In retrospect, it is clear that the robust financial structure, which was the essential element that made the tranquil performance of the economy during the first 20 years after World War II possible, was being undermined during

this period by changes in the composition of the assets and liabilities of businesses, households, banks, and other financial institutions that were almost unnoticed as they were taking place. It is now clear that a period of effective profit stabilization through deficits and asset price stabilization through lender of last-resort interventions leads to institutional and usage changes that adversely affect the effectiveness of like interventions in the future.

## THE MACROECONOMIC THEORY OF PROFITS

Any economy that is investing or which has a state apparatus will have the equivalent of profits, in that the output of consumer goods has to be distributed to those who produce consumer goods and those who produce investment goods or serve the state. Prices as a rationing device will not only cover costs but they will also carry profits. However, profits are of special importance in a capitalist economy, because the proximate owners and operators of the capital assets of the economy have, as a rule, borrowed money to obtain control of assets. This borrowing means that the operators are under contract to pay money to the lenders.

If heroic assumptions are made it can be shown that profits equal investment. As investment is an activity that is based on conjectures of what the future will bring, it can be asserted that investment causes profits. As saving equals investment after the event some have inferred that investment is somehow self-financed. Fanciful theories have been advanced that prices are determined by the need for funds by firms to finance investment and that investing firms have the market power to assure the adequacy of their mark-ups. However, even if industries are competitive, the effect of investment demand on price will generate profits.

The arithmetic result that the sum of the mark-ups of consumer and investment prices over labor costs equals investment (in the simplest Kalecki model) reflects how demand is financed and not an exercise of market power. (The emphasis on profits as determined by the structure of demand is due to Kalecki [1971]; see also Levy and Levy [1983].)

Gross profits in the first instance are earned by firms. The liability structure of firms determines the way such profits are distributed. The first function of profits in a well-behaved capitalist economy is to validate the liability structure, to enable businesses to meet the payment commitments to banks, suppliers, and bond holders that are detailed in the liability structure. Further, the value of capital assets collected in a firm depends on the profits earned by the firm. Such capital assets were brought in the past, and the flow of profits either validates or repudiates investment decisions made in the past. If validation is the general result then the state of what Keynes called animal spirits will be favorable to investment. In a capitalist economy, where investment is based

upon the views of businessmen and bankers about the course of particular profits, the maintenance of the aggregate level of profits is the first prerequisite for the maintenance of investment.

If we recognize that profits arise from the simple fact that the workers who produce investment goods have to “eat,” then any source of demand for “food” that is not the result of wages earned in the production of “food” will lead to profits. If government is introduced into the economy, and if it is assumed that income from government employment leads to the same demand for consumer goods as income from employment in producing investment and consumption goods then, after allowing for taxes, profits equal the sum of investment and the government deficit.

The critical role of profits is that they simultaneously validate the past, enable current commitments to be fulfilled, and provide both the incentives and the psychology that favor investment decisions.

There is always a question as to what stabilization policy really stabilizes. In a capitalist economy, where banks create money in exchange for business debts, positions in capital assets are financed by complex liability structures, and investment is based on profit expectations, stabilization policy will be effective as it prevents a collapse of profits. A capitalist economy in which government is big, in the sense that it spends and collects taxes on a large scale, is a system that has an in-place mechanism for sustaining profits in the event that private investment fails.

One question about the revision of the safety net that arises is whether the repeated use of the profit-stabilizing effect of government deficits can somehow or other erode the efficacy of this mechanism. In particular, over the six years of recession and recovery since 1981 U.S. government deficits have become structural rather than contracyclical. Has this, so to speak, spent the ammunition that might be needed in the next recession?

A second question that arises is whether operators in financial markets have learned that in big government capitalism, profits in the aggregate are stabilized against any significant downside movement. As they learn this, they can be expected to draw three conclusions:

1. Equity prices can be higher than if there was significant downside risk for aggregate profits.
2. The liability structure of a representative firm can carry more debt than had hitherto been deemed prudent.
3. Portfolio owners can use debt to finance their asset holdings.

Given that the protection of aggregate profits is not inconsistent with wide swings in sectoral profits, the vulnerability of the aggregate value of equity shares and financial instruments may evolve so that the protection to asset values provided by the stabilization of gross profits is eroded. The greater



leverage that is put in place because of the confidence in stability undermines stability. This leverage effect is an example of how stability can affect behavior so that the stability of the economy is compromised: Stability can become destabilizing.

## THE ROLE OF CENTRAL BANKING

In an economy such as ours, which is characterized by systems of borrowing and lending, it is possible to borrow on short-term to carry assets which yield a long stream of returns. Market rates are often such that it pays to borrow short to carry long positions. Whenever this is done, a need to refinance current debts is built into the financial structure: This need to refinance is a constitutional flaw in the financial structure.

The replacement of maturing debt by new debt is a normal financial activity. In such a structure of financial relations it is normal that during any short period some units will fail to roll over debt. When this happens, the unit is forced to sell assets. This is called "The making of position by selling out the position."

If this happens as an isolated event, in an otherwise tranquil situation, no great harm is done. If this becomes systemic or general then the price level of those capital and financial assets that are sold in the making of position can fall to the disaster level, where for broad classes of units, the value of liabilities far exceeds the market's valuation of assets.

Central banks, deposit-insuring organizations, and Treasury interventions into financial markets are all designed to prevent the need for a significant weight of units to make position by selling out position: Their primary function is to act as a lender of last resort. (The primacy of the lender of last-resort interventions is demonstrated in Giordano 1987). Between 1929 and 1933, the Dow-Jones fell from the neighborhood of 400 to the neighborhood of 40. By 1933, it was obvious that the lender of last-resort safety net in place in 1929 had failed. If the prices of equity shares are a reflection of the market valuation of the underlying real capital of the community, especially when large changes in relative prices of shares and current output take place, then the collapse of the Dow-Jones during the great contraction implies that the price level of capital assets fell to a small fraction of their prosperity level.

Over this period, the price level of capital assets fell much more than the price level of current output, including investment output. This meant that it did not pay to order investment output. As a result, investment output collapsed and, as government was small, gross profits fell. By 1933, gross profits were a small fraction of their 1929 level.

The market value of capital assets at any time reflects the flow of profits as well as the impact of the need to make position by selling out position,

whenever the need to do so arises. The initial impulse that led to the great depression might have been the result of the need to sell assets to acquire cash in a highly-fragile financial structure where the most fragile elements were outside of the protection of the Federal Reserve. The depth and the length of the depression reflected the collapse of business profits that followed.

It is worth noting that today's in-place big government makes it virtually impossible for profits to collapse to the extent that they collapsed in the 1930s. As a result of the stabilization of profits due to government, the failure of the lender of last resort to sustain asset values may not have the long lasting effect on asset values such as occurred in the past. The existence of big government means that the lender of last-resort intervention need not be as prompt and as complete as would be necessary if government were smaller: Asset prices can fall and debt repudiation can be allowed to proceed somewhat further than would be wise in the absence of the structural feature, big government.

A critical element in the initial collapse of the stock market in 1929 was the existence of a low-margin equity market: It was possible to finance positions in securities that were listed on the New York Stock Exchange with as little as a 10% ownership interest. The funds for the financing of these positions came from customer accounts and borrowings by brokerage houses from banks; in many cases, New York banks acted as brokers and the accounts were for the account of others. By the traditions and procedures of the Federal Reserve system, in 1929, the Federal Reserve had no responsibility for maintaining the value of stock exchange-linked assets in the portfolios of member and nonmember banks. In fact, we could expect that the Federal Reserve would have been severely criticized if it had taken losses on account of any intervention to protect the value of either stock exchange assets or the bank loans based upon stock exchange collateral. (The Federal Reserve intervened on October 19 and 20, 1987 to maintain orderly conditions in the Stock Market [see *The Wall Street Journal* 1987].)

## THE INTERNATIONAL DIMENSION

The new dimension that the design of a macroeconomic-safety net has to take into account is the emergence of Japan and West Germany as major independent financial centers. The great international trade deficits of the United States since the late 1970s has resulted in the accumulation of vast amounts of international dollar liquidity by the rest of the world, and most particularly by the countries with great export surpluses. This means that the two pillars of the macroeconomic safety net have to be reconsidered in the light of the new international asset and liability structures and the way in which profits created by investment and the government deficit in one country show up as profits in another country by way of the balance of trade. (This section draws heavily on Minsky [1986b].)

## The Concept of Fiscal Independence

A concept that clearly identifies the role a country need play in the international financial world if the structure is to be at all stable is that of fiscal independence. Fiscal independence can be measured by the stock of internationally-acceptable assets that the country owns and the flows of property income. When a country has a large stock of international assets and when it has a large property income from abroad then it is fiscally independent. A country that is fiscally independent needs to be a source of international funds to the debtor countries either by running a deficit on current account or by taking long-term equity and debt positions in foreign countries. In either situation, it needs to be a net supplier of liquidity.

In the present world economy, there are three countries that have serious fiscal independence, the United States, Japan, and West Germany (which may be a surrogate for the Common Market). The stop-go experience of Britain over the postwar period illustrates what happens to a country that acts as if it were fiscally independent when, in truth, it is not. The experience of France under Mitterand is another example of how a country with little or no fiscal independence is constrained in its behavior.

At present, the international financial structure is at risk because the two countries with newly-earned fiscal independence, Japan and West Germany, seem to be incapable of either making the changes in their domestic income distribution and productive regimes that would enable them to be the net importer that their financial position requires or adopting an international investing posture which supplies funds on a large scale to the highly-indebted poorer countries.

A problem that the redesign of the macroeconomic safety net may have to face is whether a regime with a number of countries that have fiscal independence is compatible with the wide swings in exchange rates among the principal currencies that have taken place since the Bretton Woods system broke down. Although the Bretton Woods system was ostensibly a multinational system it was, in fact, a dollar system. A regime of relatively restrained rates, which requires adjustments by countries with appreciating as well as those with depreciating currencies, may be preferable to what we now have.

## Beggar My Neighbor Economic Policies

Linked with the concept of fiscal independence is the idea that if a country with fiscal independence runs a persistent trade surplus then it is achieving its domestic prosperity by making its trading partners worse off. If a country persisted in such policies then its trading partners had the duty to their own to impose restrictions upon trade. In the days when the concept of beggar my neighbor had more currency than it now has, a chronic export surplus would have been the result in a regime of fixed exchanges of an undervalued currency.

Today export surpluses are likely to result from insufficiently expansive fiscal policies or an income distribution that leads to excessively high savings ratios. The need for international cooperation may be evident, but if the arguments center around income distribution, which may take the form of propositions that wages are too high or too low in one country or another, then there are no precedents for how cooperation is to be achieved.

## THE CURRENT "CRISES"

Within the United States the continued effectiveness of deposit insurance for the thrifts, even though the FSLIC is bankrupt and many institutions are open that have little or even a negative net worth, shows that deposit insurance is not now, and never was, proper insurance. Deposit insurance is viable because it pledges the full faith and credit of the Federal Government. One can of course argue that deposit insurance was mismanaged, in that little or no room was made for depositor surveillance or for coinsurance. Of course we should correct the evident flaws for the next time, but in the current crisis there is no alternative but for the Federal Government to accept that it has to refinance the savings and banking insurance institutions.

The situation with the Latin American loans in the portfolios of banks is similar to that of the thrifts. The loans will have to be either funded or written off. If funded, the banks might very well have to make interest rate concessions and quite likely they will sell out their position taking losses against earnings; the recent transference of funds to loan loss reserves by the giant banks can be viewed as a first step to the selling out of the position. (Perhaps we will see securities with these Latin loans as the corpus of the collateral in the near future.) Given that the Federal Government, through its deficits, will be able to maintain the aggregate of profits (measured in dollars) available to business and therefore to validate bank assets, the likely worst-case scenario from the Latin debt crisis for domestic credits in the United States is that a drag on bank profits may make banks more conservative. Of course, channels for the financing of Latin American expansion will be closed unless securitization fills the gap.

## CONCLUSION

On the whole the macroeconomic safety net, in the limited sense in which I have defined the idea, has functioned well enough for the domestic economies of the main advanced economies: The evidence for this assertion is that we have not had anything approximating a deep and long depression in the era of big government and activist central banking. The grim cases such as the Midlands in Britain and the slums in the United States are the result of structural problems, compounded by the inadequacy of aggregate demand due

to the constraints that follow from the international capital market. The wide swings in exchange rates, which have imparted a stop-go to the patterns of international trade, have created industrial slums in the countries that are victims of beggar my neighbor policies.

The truth of the matter is that the aggregate safety net due to big government and activist central banking has been able to function well enough over the postwar period with a wide variety of economic structures. However, past success is no guarantee of future success. The new era, in which the dominance of the United States is, to say the least, attenuated, may well see the current regime of multinationalism that gives free reign to beggar my neighbor policies, replaced by coprosperity areas. Historically, when multinational trading and financial patterns are deemed constraining, bilateralism and regionalism gain acceptance. This may be a wave of the proximate future.

The safety net that worked so well in the turbulent 1970s and so far in the 1980s was based on the unquestioned fiscal independence of the United States. Of course, this fiscal independence was used to support income and employment in the United States, but this domestic emphasis was not inconsistent with the promotion of international expansion and, given the fiscal independence of the United States, it was not inconsistent with free international trade and finance. The recent developments in finance, the wastrel fiscal policy that has promoted prosperity by a national binge of living off of capital, and the new world financial order of shared fiscal independence means that the inherited macroeconomic safety net may be insufficient. A likely result of the failure or even the continuing insufficiency of global aggregate demand maintenance will be structural changes that move the world away from the multinationalism that has ruled since World War II.

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