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Beyond Shock Therapy: The Creation of the Financial Institutions for a Successful Capitalism

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Many "a priori" reasons could have been advanced for not starting on the shock therapy route for the transition from Socialism to Capitalism. Evidence is accruing which leads one to regret the shock therapy approach which dismantled the inherited productive structure instead of taking the inherited structure as the initial condition for a dynamic process the end result of which would be a fully functioning capitalist economy. In retrospect the inherited system should have been transformed into a set of operating units, firms, which would then be subjected to hard budget constraints, and financing organizations which would look to transforming the production system into units which could stand the test of the hard budget constraints of capitalist finance.

However the past is past. The initial conditions for countries that took the shock therapy route now include the consequences of that choice. These consequences are the disruption of the inherited production process and the resulting creation of idle men and idle machines.

In some ways the post shock therapy situation in the former socialist countries is analogous to the situation in a capitalist economy after a debt deflation, when many of the production units are in involuntary bankruptcy, the ownership of the economy's productive capacity is in question and the capacity of various production units to cover their costs in the future is uncertain. The courts have to judge the feasibility of plans to reorganize the productive enterprise ant to restructure the finances of the surviving units. ~~The~~ restructuring of the financing of production units involves the writing down of debts (perhaps to zero), the assignment of the equity interests to some unit, the development of a feasible plan to become profitable and the opening of lines of credit for the reconstituted firm. Once reorganized and refinanced the unit will operate under the tight budget constraints as set out in the refinancing plan. It is to be expected that particular productive units will become bankrupt a number of times.[1]

As it is expected profits alone which make capital assets and production units valuable it is not until experience indicates that a productive unit is capable of earning profits that it is ready for privatization.

The object is to develop the institutions that can transform previously socialist economies into capitalist economies. By analogy with a great depression in a capitalist economy the following are needed:
1. A set of Industrial Reorganization Courts which would set up firms that are deemed promising out of the existing productive structure, even if they are not deemed to be fully feasible
2. A set of Public Holding Companies who would be assigned the equity in the companies. Each Public Holding Company would be assigned an Equity Fund which it could invest under court order in firms it acquires
3. A set of Short Term Credit banks which would make commercial credits available to firms. These banks are to operate under tight budget constraints and to enforce such constraints on their debtors.
4. A set of Equipment Leasing Firms which would lease general purpose equipment to firms.

These budget constraints would be enforced by a Bank for Privatization, which would be a short term financing institution, a Reconstruction Financing Corporation, which would be a Public Holding Company that would acquire the government's equity position in the newly defined firms, and a Government development office which would have a budget for subsidizing the transition agency which would fund the transformation. The problem of policy is to pick up the pieces so that a transition can be effected.

Both Capitalism and Socialism are institutional structures. The flaw in the shock therapy approach to the transition from Socialism to Capitalism is that it ignored the institutional legacy of Socialism and the institutional prerequisites for a successful capitalism. Nowhere is this

1. What follows, obviously with adjustments, is valid for socialist economies which still the operate under the now discredited planning structures.

oversight of the institutional structure more glaring than in the financial sphere.

The financial structure is the essential characteristic of a Capitalist economy. Even though financial markets and institutions are often the result of market processes and they certainly evolve as a result of market determined profit opportunities, the fundamental characteristics of the financial structure of a capitalist economy is determined by legislation which sets the framework for finance and makes the legal position of the various participants in the economic process more or less precise.[2]

Both the Soviet style Socialisms of Eastern Europe and modern Capitalist economies use expensive capital assets which are designed and put in place with the idea that these productive instruments will yield inputs which are useful in production processes for many years. In a Soviet style Socialism these productive assets do not show up in any systematic manner as the values of assets in the balance sheets of the individual households and no income (profits) are imputed to their use. If the value of such assets entered into any balance sheet it was that of the State.

The system of trade by order and the vagueness of budget constraints made the calculation of profits and present values impossible. The data needed for the computation in markets of the numbers needed for capitalist rationality in portfolio choice and investment decisions were not generated by the normal functioning of the Socialist economies.

A "great evasion" surrounds the discussion of what is going on in Eastern Europe: this evasion centers around describing the process as a shift to a market economy. As every Economist knows in the abstract a Socialist economy could be operated on the basis of a market determination of outputs and prices. Perhaps it would have been possible to have created a market Socialism in 1968, but the breakdown of the Soviet created systems in the east makes this an obsolete definition of what is at hand. What is at hand in Poland, Hungary and Czechoslovakia is the creation of Capitalism.

Capitalism is first a financial system which takes the form of the private ownership of the bulk of the productive resources of the economy. In early and crude capitalisms this took the form of simple ownership of productive resources which because they were rarely sold may not have had a clear market value. Today, when the corporate form is the main way in which the proximate ownership and the

2. H.P. Minsky "Central Banking and Money Market Changes", QJE, 1957

operation of the productive assets of the economy is organized, the private ownership of the wealth of the economy takes the form of corporate liabilities, such as short term bank and open market borrowing, longer term bonds, leases of capital assets, and common stocks, which are directly or indirectly owned by the ultimate financial units, households, endowments or the state. This pass through to households and to the various other ultimates, by means of a variety of financial instruments and institutions which act as intermediaries, of the values of the capital assets of the economy as collected into firms is the dominant characteristic of a modern Capitalist economy.

This financial structure leads to the setting of values upon firms and implicitly upon the value to firms, both existing and potential, of capital assets and investment outputs. Underlying these valuations are the cash flows (gross profits inclusive of depreciation charges and interest commitments on debts) which firms earn in the market. Capital in a capitalist economy is always the present value of cash flows and the value of a firm is always the market valuation of its debts and equities. Debts and equities are contractual and contingent commitments to make payments and financial markets such as the New York Stock Exchange are valuing these commitments throughout the trading day.

The financial structure of a Capitalist Economy not only passes through the gross profits earned through to the various claimants according to an established, by contract, hierarchy of claims, but it also provides the mechanism for the financing of investment, what Keynes called the "capital development of the economy."

The fundamental weakness of the shock therapy approach to the transition from Socialism to Capitalism is that it makes no allowance for the capital development of these economies, given the peculiar initial conditions which rule. A dominant initial condition is that there is no pass through of the value of the productive capacity of the economy to individual portfolios: there is no private wealth. This also implies that there are no property rights to the cash flows that profitable firms will generate.

Another dominant characteristic is that there are no institutions in place which can finance the capital development of the economy. The main task of the next step in the building of capitalism is the putting in place of a set of institutions which can use capitalist rationality in the selecting of investment projects, in valuing firms and in selecting managements.

There are three models of investment oriented capitalist financial structures. These are the specialized financial institution plus capital and money market route of the United States and Great Britain, the Universal Bank route of Germany and the Public Holding Company, the route of Italy in its post war development and of the United States during the great depression. None of the real world economies are pure examples of these models.3

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bankruptcy as a device for refinancing a firm not necessarily a device for liquidating firms. The state will have to pick up the pieces for much of the Polish industrial structure as it is transformed into a collection of firms that meet the market test.

There is a coordinated need to create a rational taxation and spending structure for the new state. A balanced budget as a means of assuring the credit worthiness of the state, especially as the states capital will need to underwrite the public holding companies. Import duties and much more fee for service supplying of services by the state.

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THE DESCRIPTION OF THE THREE MODELS

tHE UNITED sTATES: a HORSES FOR COURSES MODEL, iTS CURRENT DIFFICULTY IN ASSIMILATING THE NEW PATTERN OF INDIRECT OWNERSHIP

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3. An interesting aside is that in the post world War 2 occupation of Germany the United States and its allies imposed an Anglo-American financial model upon Germany but as soon as the Germans regained some measure of autonomy they began an evolution which led to the present pattern. Incidentally the German model is not just a set of Universal banks but it also allows for specialized and local-regional financial institutions. Furthermore the German model allows for government participation in ownership of industry.