Banks are the central financial organization of a capitalist economy. Once the assets and liabilities of banks are set, the economy's financial framework is largely determined. As bankers pursue profits they change the composition of their assets and liabilities; in particular, during good times the interactions between bankers and their borrowing customers increase the weight of assets reflecting speculative and Ponzi finance in the balance sheet of banks. As a result, the financial system evolves from an initial robustness toward fragility, and continuous control and periodic reform of the banking system are needed to prevent the development of a financially unstable economy that cannot readily be contained.

There is a correlation between the size of a bank and the size of business it can serve. A decentralized banking system with many small and independent banks is conducive to an industrial structure made up of mainly small-and medium-size firms. Similarly, a highly concentrated banking system made up of large banks with branches throughout the nation is conducive to industrial concentration.
a bank with a lending line limit of several million dollars cannot handle the short-term financing needs of a giant corporation. Such a corporation naturally gravitates to the largest banks. Furthermore, the bank financing needed by a corporation in the billion-dollar class cannot be handled by any single bank; giant and even moderate size firms have multiple bank connections and lines of credit. No matter where a very large firm has is headquarters, it will have financing relations with the giant money-center banks.

Over the past decades, although the geographical autonomy of banking has been eroded, the United States has not traveled far along the road that leads to a banking system dominated by a small number of giant banks. Even though the system remains decentralized, the banking laws and their administration should be structured to foster the growth and prosperity of independent, smaller banks. This is not the direction the current changes in bank regulation and bank legislation are taking.

As pointed out in chapter ten, when banks finance a business, they become a partner in the business, for the repayment of the loan depends upon the success of what the borrower undertakes. Furthermore, Banks and their business partners generally do repeated deals; they have a continuing relation.

As a result, bankers, motivated by the partnership in which the borrowing customer’s prosperity determines the banker’s profits, are sources of continuing advice for and
guidance to businessmen. To serve these customers fully, a banker should offer a wide array of financing options, both as a lender and as a placement agent. Restrictions on banks acting as dealers, underwriters, and financial advisers are unwarranted legacies of the 1930s.

To properly use the energies of the smaller banks for economic development, they should be allowed to function as investment and merchant bankers as well as commercial bankers; they should be allowed to underwrite and place equity and bond issues of smaller businesses.

Since specialized organizations already handle the investment and merchant banking needs of large firms, there may be merit in not allowing giant commercial banks to act in this capacity. Wall Street is not the entire economy. For many businesses the major locally available sophisticated financial advisor and guide—as well as the only practicable underwriter for equity issues or debt placements—is a commercial bank. If economic policy aims to support competitive markets, then commercial banks of modest size should be free to be underwriters, place debts with third parties, give financial advice for a fee, collect fees for arranging mergers, divestitures, and takeovers. The Federal Reserve tries to control the aggregate ability of banks to finance or to create deposits by regulating the reserve available to banks. If banks and financial markets were simply deposit-creating automatons and only affected economic activity by way of the excess or deficit of cash in
portfolios, then the attempt to control the economy by controlling bank reserves might have some merit. In fact, banks are complex profit-seeking organizations that have a multitude of actual and potential types of liabilities and that innovate in response to profit opportunities.

In order to contain the destabilizing effect of banking it is necessary to regulate the amount and the rate of increase of bank assets. The major control device is the permitted capital-asset ratio and the rate of growth of bank capital. As things now stand, the adequacy of bank capital is a concern of bank examination and supervision, not of monetary policy. In order to constrain the disequilibrating potential, to protect against debt deflation, and to remove the bias due to the higher asset-equity ratios allowed to giant banks, the Federal Reserve should be authorized to set an asset-equity ratio for all banks—that is, all institutions with deposits subject to transfer by check or withdrawal on demand. A 5 percent asset-equity ratio seems reasonable, especially if capital absorption by covert bank liabilities is taken into account. The Federal Reserve should have a right to vary the ratio if aggregate bank capital is compromised. A capital-adequacy condition should not be administered as a straightjacket, and a penalty constraint upon dividends should be assessed for significant shortfalls of capital.

The ability of the smaller banks to lend and invest will be increased by such uniform capital-asset ratio. The
problem of these smaller banks will still be to find assets and to place liabilities. More favorable financing conditions for smaller enterprises will result from the higher allowable asset-capital ratio of the smaller banks, for they will be able to earn the market-determined markup on money costs at the small banks might well fall even as the markup of the big banks rise. An evenhanded asset-equity ratio among banks will go some way toward equalizing the financing conditions of large and small businesses.

At present a well managed, reasonably profitable bank can retain earnings so that its capital grows at a rate that exceeds the sustainable noninflationary growth of the economy. In order to have an internal rate of growth of bank equity consistent with stable prices, the pay-out ratio for bank earnings will have to rise.

Control over the capital-asset ratio and the pay-out ratio for banks are powerful weapons for guiding the development of banking. Once set, the uniform capital-asset ratio should be granted the power to vary the pay-out ratio if the growth of bank equity is too fast or too slow.

Ease of entry or free entry into markets should also be a policy objective. Banking reforms that remove barriers against flexible financing options from the smaller banks should also ease entry into banking.

Banking is not so profitable that free entry would lead to an explosion of bank capital. The control of the rate of growth of banking by means of limiting retained earnings is
more likely to lead to noninflationary increase of available finance than the proven futile effort to govern the expansion of bank assets by regulating bank reserves.

Banks provide a large portion of the in-being and stand-by credit used by business and nonbank financial institutions. If banks concentrate on the to-the asset financing, then the short-term debts of business will lead to payment commitments that are consistent with business cash receipts. The bank debts of firms would be part of a hedge-financing relation.

The idea that banks should be constrained to to-the-asset financing is a tenet of the real bills doctrine. This doctrine holds that if banks only financed goods in the process of the production, then the right amount of money would be created; this right amount of money would lead to stable prices. It has long been known that restricting assets of banks to real bills could not prevent an inflationary growth of the money supply.

The idea is not so much to assure that a noninflationary quantity of money exists, as to assure the stability of the financial system. This implies that profit opportunities of banks must be biased by the regulatory authorities to favor hedge financing, and the to-the-asset financing of inventories is a form of hedge financing.

The Federal Reserve Act initially provided that only bank loans reflecting short-term to-the-asset financing were eligible for rediscounting. In the early years of the
Federal Reserve, rediscounting was a major source of bank reserves. After the crash of 1929, the dominance of rediscounting as the source of bank reserves gave way to the use of open-market operations in Treasury securities.

When the Federal Reserve acquires assets as a result of financing some activity, then the banking system acquires reserves or the public acquires currency. If the Federal Reserve mainly acquires Treasury debt, as it does when open-market operations are the source of bank reserves, it abets the financing of government activities. But when the Federal Reserve acquires private business debts through the discount window, it is mainly cofinancing business. In addition, if the Federal Reserve supplies reserves through the discounting of to-the-asset short-term business debt, the Federal Reserve is participating in and encouraging hedge financing.

Thus, bank reserves against overt liabilities should be retained much as at present, even though their main function has changed; they are valuable not as a means of affecting economic activity but because the process of creating reserves through out the discount window makes the Federal Reserve a participant in the financing of particular activities by particular instruments. Inasmuch as this cofinancing increases specific supplies of credit and makes these supplies more assured, participation by the Federal Reserve will guide business and bank financing practices.
There are pervasive influences that reflect fundamental characteristics of a capitalist economy that lead to instability. Biasing banks in favor of short-term to-asset financing will attenuate this thrust. Other financial institutions—sales finance companies, life insurance companies, even ordinary business corporations—should also have direct or indirect access to the discount window by discounting eligible paper. The eligibility requirement for discounting can be used to assure that to-the-asset financing flourishes.

Central Banking

The evolution of financial practices must be guided to reduce the likelihood that fragile situations conducive to financial instability will develop. Central banks are the institutions that are responsible for containing and offsetting financial instability and, by extension, they have a responsibility to prevent it.

Central banks affect the normal functioning of the financial structure because they intervene in financial markets. Restricting the central bank to the regulation of member banks and to the control of the money supply is wrong. Regulating commercial banks or money may have been a good enough definition of central bank responsibility when other financial institutions were less important, but such restricted responsibility is no longer appropriate.
A central bank, as a lender of last resort, must assure that the supply of funds in key position-making markets is not disrupted by a run, and it must clearly define the financial markets it will protect. The lender-of-last-resort intervention is a delicate operation that allows particular units and branches of industry to fail even as it assure that the total available financing does not collapse.

Central banking increases in importance when the financial structure is such that business liabilities need to be refinanced. In particular, central banking exists because Ponzi and speculative financing exist. As long as commercial banks do the financing, refinancing, and contingency financing of non-bank speculative financing organizations, the central bank need deal directly only with them. But the central bank, even if it deals only with commercial banks, needs to recognize its responsibility for the normal of all finance.

During the great contraction of 1929-33, the Federal Reserve System did not prevent the breakdown of the financial system. As a result, a number of specialized partial central banks were created, making the actual United States central banks a decentralized operation, with the Federal Reserve as the preeminent body. A minor, but not insignificant, structural reform would have the specialized institutions-FDIC, the Comptroller of the Currency and the specialized insurance and supervisory agencies for thrift institutions-become departments within the Federal Reserve.
In a modern capitalist economy with a complex financial structure, innovations result from profit opportunities. Central banking is a learning game in which the central bank is always trying to affect the performance of a changing system. Central banking can be successful only if central bankers know how the institutional structure behaves and correctly assess how changes affect the system. Central banks have to steer the evolution of the financial structure.

The central bank controls its own portfolio, except where the law lays down provisions, as with a gold standard, that all of some asset offered or demanded must be bought or sold. The central bank affects how business is financed by its power to define the assets it will protect and by selecting the assets it will use to furnish reserves to the banking system. The assets it acquires in creating reserves finance some activity which then receives favorable terms. As long as banks need central bank deposits as reserves and as long as the central bank has a monopoly of currency issue, the central bank can affect bank portfolios.

If finance is robust, speculative and Ponzi finance characterize a small portion of the financing posture of business and businesses hold substantial stocks of money and other liquid assets. Robust finance means that bank assets will be heavily weighted by government debt and private debts that reflect hedge financing. In these circumstances,
it is all right for the central bank to operate mainly in Treasury debt.

In a robust financial structure, open-market operations can constrain the financing available without inducing significant present-value reversals. When investment in process is largely financed by investor’s own rather than borrowed funds, the cash needed to fulfill payment commitments does not increase substantially when interest rates rise. In addition, long-term financing terms and asset values will not react strongly to transitory changes in short-term interest rates. Thus, variations in financing terms by banks will have an effect on the level of activity, but not on the viability of financial relations. Central bank efforts to restrict bank lending by decreasing bank reserves will not lead to a decline in financing available from banks; banks will simply substitute business debt for government debt in their portfolios. The effect will be on interest rates on Treasury debt.

But a robust financial environment is a transitory state, for it means that credit can expand more rapidly than the credit base during periods of expansion and can contract less rapidly when the base contracts. The cumulative effect of such bank credit changers leads to a fragile financial system. In the shift to fragility, the use of Treasury debt by banks as the position-making instrument decreases.

If Treasury debt is not used as the position-making instrument, even as the operations of the central bank are
mainly in Treasury debt, no direct business contact exists
between commercial banks and the central bank. If a banking
system is fragile, constraint of bank reserves is almost
fully reflected in the rate of growth of bank loans; there
is no Treasury debt safety valve or shock absorber. Thus, a
given central bank action has a larger effect on available
financing and interest rates in a fragile than a robust
financial structure.

In a fragile financial environment, central banks
cannot blindly follow rules and apply techniques that were
successful when the financial system was more robust. When
Treasury securities are of small in bank portfolios and are
not the position-making instrument, open-market operations
are an inept way to guide the financial system. Variations
in bank reserves must be related to the assets owned by
banks; the discount window is the appropriate instrument for
controlling reserves. The need for banks to cofinance their
assets by borrowing from the central bank is a central bank
technique that can influence banks’ asset preferences and
thus affect the way business is financed.

If business and banking practices can lead to a fragile
financing structure, the central bank has a responsibility
to operate to induce banks to hedge-finance business. The
authorities must look through the veil of the bank’s balance
sheet to the balance sheets of the organizations that the
banks finance.
The first question a banker asks a potential borrower is, "How are you going to repay me?" The same principal should guide the management of the central bank. The access of banks to central bank cofinancing should be through business assets that reflect hedge financing.

The Federal Reserve should stop relying upon open-market operations to determine reserves of the banking system. As an alternative to open-market operations, the Federal Reserve can furnish bank reserves by discounting bank assets. In the discount technique, bank reserves are furnished when the central bank buys or lends on specified, eligible types of paper that are a result of financing business,. The Bank of England money-market relations prior to World War I can serve as a model for an apt relation between the Federal Reserve, commercial banks, and money-market institutions. In this model, the Reserve base of banks (as well as the currency supply) would be largely the result of the Federal Reserve's discounting bank loans (or open-market paper) that arise in the financing of short-term business activity. The preferred or eligible paper for Federal Reserve discounting would be to-the-asset paper that reflects commercial or manufacturing inventories. Thus, once the financial system is fragile, the classical British discount market structure is appropriate for central bank control over the short-run supply of credit.

If bank reserves are largely the result of discounting short-term paper tied to the ownership of business inventories, then as loans fall due and are repaid bank Reserve balances fall. To bring reserves to target levels, banks would have to discount paper and there would be a continuing business relation between banks and the Federal Reserve. Thus, a major necessary reform is for the Federal Reserves to shift from the open-market technique to discounting. The discount window method for creating the Reserve base induces favorable terms for the hedge financing of short-term positions and blunts the tendency toward fragile financing structures.

In the discount-window technique, the Federal Reserve uses paper that arises as business is financed to create reserves. The Federal Reserve both creates a market for this paper by its purchases and assures that it will have a protected status in financial markets. Such paper will therefore be in a preferred risk class. the guidance of the structure of financing relations will run from the Federal Reserve portfolio to a favored interest rate in the market for the eligible paper.

In this system, a portion of the Reserve base is extinguished each day and the market needs to discount at the Federal Reserve in order to replenish reserves. In a complex financial structure, each bank will have a variety of ways to make position. A net deficiency of reserves, however, will lead to some banks borrowing at the discount
window. Each bank should have a line of credit at the
discount window and be able to borrow up to its line at a
preferred rate; borrowing above the line of credit will be
at a penal rate. The bank's line of credit at the preferred
rate might very well equal its capital and surplus account,
thereby inducing banks that have high asset-capital ratios
to retain earnings.

The interest rate for rediscouting set by the Federal
Reserve becomes the critical rate in determining financing
terms. In particular, bank and money-market rate for
financing by means of ineligible paper will be at a premium
over the rate on eligible paper. Thus, the interest rates on
speculative and Ponzi financing will be higher than on hedge
financing. Although the supply of reserves would be
infinitely elastic to all who hold eligible paper, the
interest rate would be fixed by the Federal Reserve
according to its presumed impact on the economy.

The Federal Reserve would have two controls over bank
financing. One would be the capital requirement, the second
the reserve requirement. The capital requirement is a
longer-run constraint, with a penalty device on dividends
and perhaps on the discount rate for falling below target,
whereas the Reserve requirement is shorter-term control.

In the present system it is difficult to discover or
invent a serious reason for the existence of twelve Federal
Reserve Banks. The New York Federal Reserve Bank is the
agency for Federal Reserve Operations and therefore is the
only one that has a reason for being. If the Federal Reserve shifts to a discounting technique, then the highly decentralized banking system will require regional money markets. The regional Reserve banks would then have a lender’s relation with individual banks and with the district’s money market; the district setup is compatible with a discount-window operating technique.

The discounting technique sets up financing relations between the central bank, commercial banks, and various money-market institutions. Bankers well recognize that a lender has the right to look over the shoulders of borrowers in order to be assured of their continued probity and creditworthiness. The Federal Reserve, as the potential and actual lender to commercial banks, would have the right to look over the shoulder and comment on the adequacy of a banks practices. Too great a growth of ineligible paper would mean a review of the availability of credit for a bank. Bank examination would then be natural outgrowth of the banking relation between banks and the Federal Reserve.

The volume of bank holdings of eligible paper may decrease because of a decline in the borrowing needs of business, as happened in the great contraction of 1929-1933. A similar contraction cannot take place in a world with Big Government and the large deficits that occur in a downturn. The deficit means that financial markets have to absorb Treasury securities—as private debt decreases banks can keep fully invested by acquiring Treasury debt. Once banks
acquire Treasury debt the Treasury-bill market is an effective position-making market. When banks are acquiring Treasury debt and the Federal Reserve wishes reserves to grow rapidly, it can augment the reserve base by purchasing Treasury bills from the open market.

Thus, the mechanism by which the Federal generates the reserve base must adjust when the instruments used by the banking system change. The discount window—discount market technique of reserve creation is appropriate for a system in which financial crises can occur because of the development of liability structures heavily weighted with speculative finance. Encouraging paper tied to the assets that flow through the production processes is a way of favoring hedge finance, although in a capitalist world a thrust to speculative financing will always take place during tranquil times.

Because a thoroughgoing debt deflation leading to a deep depression cannot occur as long as government is big, the significance of the Federal Reserve's lender-of-last-resort function changes. After a financial trauma, the Federal Reserve needs to facilitate deficit-financing by making bank reserves available outside the normal discounting channel.

Because Big Government sustains profits, the Federal Reserve can stand back and allow firms and financial institutions to go bankrupt before it steps in and refinances. Federal Reserve intervention should operate
under the principle that organizations that are fully viable at normal incomes with a restructured debt and normal financing terms, but that are not solvent or liquid with crisis financing terms and recession incomes, are eligible for concessionary refinancing. The longer the Federal Reserve delays its intervention, the larger the decline in income and employment following a crisis. On the other hand, the quicker the intervention, the sharper the subsequent rise in prices and the more fragile the financial structure with which the next expansion begins.

Whenever the Federal Reserve steps in and refinances some positions, it is protecting organizations that engaged in a particular type of financing, and is expected to do so again. But it is an untoward expansion of speculative and Ponzi finance that causes the fragility that leads to a crisis-prone system. The central bank virtually assures that there will be another crisis in the near future unless, of course, it outlaws the fragility inducing financial practices. Clearly central bank lender-of-last-resort interventions must lead to legislated or administered changes that favor hedge financing.

The Federal Reserve can deliberately trigger a financial crisis by adopting a sufficiently restrictive posture with respect to bank reserves. Such a monetary policy introduces uncertainty into portfolios, even as Big Government and lender-of-last-resort interventions reduce uncertainty. If Federal Reserve policy instruments are used
to force crunches and squeezes, then the future growth of portfolios that lead to fragile financial structure is constrained.5

Federal Reserve policy therefore needs to continuously "lean against" the use of speculative and Ponzi finance. But Ponzi finance is a usual way of debt-financing investment in process in a capitalist society. Consequently, capitalism without financial practices that lead to instability may be less innovative and expansionary; lessening the possibility of disaster might very well take part of the spark of creativity out of the capitalist system.

The Federal Reserve position favoring hedge financing does not mean that Ponzi and speculative financing will not take place. The need to structure deals means that bank loan officers and loan committees will always face situations when activity they are financing is really a Ponzi deal-in that next-stage borrowings are expected to provide the funds to meet the interest and principle.

If the central bank is leaning against speculative and Ponzi finance, and commercial banks are authorized to engage in underwriting, then bank loan officers can arrange for the funding of bank loans into either intermediate-or long-term bonds or equities. A financial structure in which commercial banks have access as middlemen to life insurance companies,

pension funds, other money managers, and private persons for the placement of the debts and equities of their customers is conducive to hedge financing.

The sustaining of hedge financing by business is a major, proximate policy objective of the Federal Reserve. The more the Federal Reserve can tilt banking toward financing trade and production inventories with short time spans, the more stable the financial system and the smaller the special refinancing needed to prevent a full-blown crisis. A financial structure that is supportive of stability must start with the techniques available to corporations to finance capital-asset ownership, continue with the biasing of banks toward to-the-asset financing, and finally change the perceptions, objectives, and instruments of the Federal Reserve.

**Industrial Policy: Alternatives to Dominance by Giant Corporations**

The institutionalized and bureaucratic nonspecialized corporations that now dominate business are young. Corporations, as we know them, did not exist in 1776, or even 1876. They became the dominant form of business organizations because they can issue long-term and equity shares that are not tied to the fortunes of specific persons or assets. Because of this the financing costs of long-lived, specialized, and expensive capital assets for corporations are lower than for proprietorships or
partnerships. Corporations thus foster the dominance of capital-intensive production techniques and tilt the economy toward the use of laborsaving techniques.

The result of the dominance of capital-intensive production techniques can be chronic labor surplus. It is now necessary to invent and promote enterprises that put idle and potentially productive labor to work. Policies are needed to enable labor-intensive and capital-intensive modes of production to coexist.

The role of the corporate form of organization is a proper concern of policy, but policymakers should distinguish between bureaucratic and institutionalized corporations on the one hand and entrepreneurial corporations on the other. The first draws its strengths from its financial position and market power. The management of a bureaucratic corporation is professional; its leading officers either progressed through the ranks or were hired from outside as executives and had little if anything to do with the founding and earlier growth of the corporation.

An entrepreneurial corporation, however, is largely the extension of the personality of a founder or a founding group. Its present leadership is mainly responsible for the organization’s growth and development. Even though it may now be financially strong, its main strength does not rest upon its financial resources.

Competitive markets are devices to promote efficiency, and ease of entry is a mechanism that promotes competition
and change. The market is an adequate regulator of products and processes except when market power or externalities exist; once they exist—whether caused by government or by market processes—regulation can be necessary to constrain the exercise of power.

Regulation and government intervention in markets are valid when they make markets behave as if they were competitive markets. Such intervention is necessary when market power exists or when other reasons lead to market failures. Interventions to constrain or channel market power are necessary. An industrial policy that takes the form of promoting competitive industry, facilitating and aiding and abetting the development of labor force that is trained and productive, is highly desirable.6

Government and society are also suppliers of knowledge. The utilization of knowledge by competitive industries guarantees that such knowledge becomes the basis of widespread well-being, not the rent-producing assets of a few. In addition regulation and intervention are devices for assuring that cross subsidization takes place in the form of guaranteeing some minimum level of services to units that may not be able to cover the out-of-pocket, let alone the capital costs, of these services.

In a world where profits are cyclically unstable, market power can arise from the banker’s requirement that

unfavorable outcomes must be constrained before capital-intensive production techniques are financed. Once market power, however, it can and has been exploited to restrict output, to impede the entry of firms, and to sustain prices and profits. In these conditions government intervention to set rules of fair competition or to create results in markets where power exists that mimic competitive solutions is indicated. At best, regulation to control and channel market power has enjoyed transitory success: all too often the regulated becomes the regulator.

In a small-government capitalism where aggregate profits are unstable, the requirement by bankers that the units being financed have market power is sensible. In Big Government capitalism, market power leads to markup increases and the dissipation of profits into business-style overhead costs. The prolix corporation with a huge overhead that is capable of losing a billion dollars a year or more when demand falls is the result of the allocation of profits that result from the exercise of market power to business-style overheads.

Once Big Government stabilizes aggregate profits, the banker’s reason for market power loses its force. Obviously, with overall profits sustained it is possible for a particular corporation to make losses; presumably such losses are due to inept management decisions or impersonal and unforeseen developments that affect the markets for particular products. Special-purpose and long-lived capital
assets will still be able to find financing even in the absence of market power if the prospects for validating cash flows pass a serious scrutiny. Experience with Chrysler, Lockheed, and the various debacles in nuclear energy shows that market power is no substitute for bankers and investors doing their homework.

Anti-trust, as presently operated, is a failure; the legal approach to anti-trust has meant that the issues of market power are not addressed. An industrial policy aimed at generating conditions conducive to competitive markets should investigate policies that set a size limit on the assets or employees that any particular organization can deploy. The size limit may vary, depending upon the industry.

Much of the growth of corporations to gigantic size reflects financing and financial-market conditions. The proposal that central and commercial banks shift to to-the-asset financing and diminish the availability of short-term to-the-firm financing will remove some of the advantages of giant business. The proposal that smaller banks be allowed to act as investment bankers for their customers would also decrease some of the financing advantages of giant firms. In addition, allowing smaller banks to act as investment bankers would facilitate the entry of firms into various industries.

The changes in the corporate income tax and shift in the Federal Reserve operating techniques that were discussed
earlier, along with the greater availability of investment banking facilities for smaller business, should facilitate the entry of new firms and the expansion of existing smaller firms.

With an effective minimum wage provided by the WPA device and stabilized aggregate profits, a generalized fall in wages and prices of the dimensions of the early 1930s cannot recur. Those devices in agriculture, labor, manufacturing, and trade that constrain downward price flexibility are therefore not relevant to a properly organized Big Government capitalism, because they tend to exacerbate inflationary pressures.

As is evident from the history of there railroads, some electric utilities, Lockheed, and Chrysler, the present fluctuations in interest rates, unemployment, and inflation lead to an erosion of the financial strength of many corporations. Since many corporations now carry heavy debt burdens, the loss of market-power protections resulting from tax and finance reforms will cause them financial difficulties. Furthermore, any positive limitation on size of assets managed will undoubtedly begin by making only several of the very largest firms candidates for devolution into several smaller, more manageable units.

The United States has a broad and deep capital market that can handle equity and debt issues of enormous size. This ability of the capital market to handle large issues means that socialization of industries that require
financial restructuring can be considered a transitory step. When a Chrysler is bankrupt, the bankruptcy should be handled by a government refinancing corporation, which would take over the business and break it into parts that can survive in the market and parts that cannot generate profits. The first potentially or even presently viable part should be sold off in the capital market as anew and independent private entity. The second nonviable part may be viable as a high-risk possibility if enough new funds are forthcoming. If the financing corporation sees an ability to go private at the end of some period of reconstruction, then the funds to rebuild and restructure should be forthcoming. If not, the Government refinancing corporation should proceed to liquidate the remnants.

There are two capital-intensive industries that private enterprise manages poorly: railroads and nuclear power generation. Both are industries combining capital intensity with enormous externalities. Although even the suggestion raises difficult political questions, public ownership should be tried; where these industries work well in other advanced economies they are almost always publicly owned. At this writing, there is no way the enormous funds needed to reconstruct these industries with relevant technology will be forthcoming except through some government-financing device; the simple straightforward way- and one with historic precedent to lessen the political problems that would be raised-is to set up a government agency like the
Tennessee Valley Authority to manage these parts of the economy.

The railroads are not only capital-intensive, they are also large-scale employers. One of the recent lessons to be learned from the experiment with revenue sharing in various forms is that subsidies and free monies are quite often turned into higher pay and more elaborate bureaucracies for employees. A Government employee-government industry wage policy is necessary prelude to massive government investment in industries such as railroads and nuclear electricity generation. Although a generalized wages and incomes policy is not feasible because it cannot be administered, a government employee-government contract wage policy can be effective.

Conclusion

The policy failures since the mid-1960s are related to the banality of orthodox economic analysis. In turn, the banality of economic analysis is related to the transformation of Keynes’s economics from a serious critique of capitalism to a series of trivial policy manipulations. The essential Keynesian result is that capitalism is flawed mainly because it handles capital poorly, nowhere enlightens current policy actions. Policy and mainstream economic thinking about thinking about our economy blithely ignores
the need for and effects of lender-of-last-resort interventions by the Federal Reserve.

Keynes recognized the flaws in capitalism because he, more than his predecessors, contemporaries, and successors, understood the financial and time-related aspects of a capitalism that uses capital. The Big Government socialization of profit maintenance and lender of last resort mix policies that were legitimized by Keynes's analysis eliminated the possibility of a deep depression. As a result of Big Government, a regime in which free competitive markets are the instrument for constraining inflationary pressures on prices become palatable. The Big Government that is needed can (and does) provide floors to the economy that assures minimum levels of living and service to all, thereby making the argument that free markets will lead to a degradation of labor standards irrelevant. Once we recognize and accept the fact that a government that is big enough to constrain fluctuations in aggregate profits is a prerequisite for a successful capitalist economy, thee economy can be restructured to remove barriers to competition and to simplify liability structures. Only an economics that is critical of capitalism can be a guide to successful policy for capitalism.

The policy suggestions that have been put forward here are best interpreted as an agenda for discussion rather than a nonnegotiable program. The analysis argues for a system of changes, not for isolated changes. There is no simple answer
to the problems of our capitalism; there is no solution that can be transformed into a catchy phrase and carried on banners.

Every gain has a cost. But in an economy that lives in historic time, the gain may precede the cost. Between 1946 and 1966 we, along with other advanced capitalist economies, had the gain of a long period of improvement that left people as a whole substantially better off in 1966 than in 1946. In the years since 1966, the economy has been much more unstable and further gains have been small and insecure. Furthermore, on several occasions a deep depression threatened, which if realized, would have undone much of the good of 1946-66.

What is needed is a restructuring of the economy, reducing the inflationary impetus due to Big Government even as it retains the power Big Government to prevent deep depressions. Such a restructuring will enjoy only transitory success. After an initial interval, the basic disequilibrating tendencies of capitalist finance will once again push the financial structure to the brink of fragility. When that occurs, a new era of reform will be needed. There is no possibility that we can ever set things right once and for all; instability, put to rest by one set of reforms will, after time, emerge in a new guise.