The Transition to a Market Economy:
Financial Options

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Prepared for a conference at Castle Szirak, Hungary
August 30-31 1990
INTRODUCTION

The transformation of society in Eastern Europe has proceeded much faster and the destruction of the legitimacy as well as the efficacy of communism has been more complete than was deemed possible when we last met here two years ago. Like all revolutions it has not been a reasoned and deliberate process: no one has been in charge and no coherent view of the society the revolution aims to achieve has emerged. The purported aim of achieving a market economy is no aim: there are many varieties of market economies, the concept is not precise.

The transformation began without any serious body of available literature on problems of the transition from a command or planned socialist economy to capitalism or even to a market economy, whether capitalist or socialist. As a result the process has been both rapid and helter-skelter: furthermore there is a great deal of public impatience. It is understandable that the idea that real results take time is not popular in societies in which so much has been sacrificed for so long to build a better tomorrow only to learn that no such building was taking place.¹

¹. It almost seems self evident that the so called planned economies were not in any serious sense planned. In serious planning the general interdependent relations in production and consumption are considered. The obvious disregard of the conditions of the labor force and of the environmental impact of industry in the Eastern European economies is prima facia evidence that interdependent relations were disregarded, i.e. development was anarchic not planned.
There is little in the discussion that I know of, and I do not claim to be into the large literature that I am sure has developed on the subject of the transition, about the salient fact that differentiates market economies, whether conservative capitalist or social democratic, from the economies based on Leninist - Stalinist principles. The salient fact is that market economies are financial systems in which personal claims to and realizations of income are derived from the profits made by industry and trade.

Financial systems consist of institutions, instruments and markets by which commitments to allocate future income to fulfill financial contracts are made and traded. These commitments are owned by units in the economy and as such are claims to receive incomes in the future. These commitments are first created in an exchange where money is paid today (or promises to perform are made today) in exchange for particular claims to future incomes or cash flows. The cash flows, above what are needed to meet wage bills, tax bills and purchases from other units, to the holders of financial instruments are conventionally called gross profits. As a result of past promises, the cash flows that are realized at any date are allocated among claimants as stated by the stock of outstanding financial instruments and entries on the books of financial institutions.

These claims are accepted as legitimate because the right to these cash payments were created by prior payments:
rents, interest and dividends are legitimate because they reflect the money later part of trades in which money now was exchanged for money later. The money now paid for investment output, state spending or foreign goods. Those who acquire financial instruments from the market after they have been created in some initial financing transaction acquire legitimacy for their claims from the original transaction.

It is obvious that questions of the legitimacy of rights to future income can arise in the privatization of a public domain: the difference between the honest homesteader and the Robber Barons in American history comes to mind. The lesson from history is that privatization should be done very carefully especially if the capital assets were created without initial private financing. Questions of how to create legitimate titles need to be addressed in discussions of the transformation of Eastern Europe.

In a capitalist economy investment and positions in capital assets are financed by exchanges of money now for money later. The receiver of the money now presumably uses the funds to invest and has an acceptable answer to the essential banker's question "How are you going to get the monies to repay me?". (The money now for financing investment includes earnings retained rather than distributed: presumably the in-house decisions relating to retained earnings pass the same test as the external financing. We also know that there are many cases where the
The financial system thus provides for linkages through time: exchanges of money for well defined claims to future money flows are made each day. Furthermore each day is the future of deals that were struck in the past. The financial structure and the physical capital assets of a capitalist economy link the present to the past and to the future.\(^2\)

Because of these financial linkages in a capitalist economy between the past the present and the future, which is always conjectural, simple linear models that abstract from money and finance violate the true character of a capitalist economy. In particular business cycles that are linked to endogenous financial crises and the pay off from government regulation and intervention which prevent or contain crises and depressions are non starters when a theoretical structure where money and finance are ignored is used for policy making.\(^3\) Policy making for the economies that are building market economies from so to speak scratch

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2. In a Leninist-Stalinist socialism the link of today to the past is only in the capital assets available for use today and the link of today to the future is by way of gross investment and capital that is carried over.

3. The Savings and Loan crisis in the United States is a result of the gradual breakdown of the regulatory system over the post war period and a corrupting of the regulatory system in the 1980’s. What is being called the bailout is the use of government fiscal strength to prevent the breakdown of the S&L’s from triggering a big depression. Because the government is being operated by those who accept the advice of good ole neo classical economists - in neoclassical theory finance really does not matter - they know not what is happening and they therefor know not what to do.
should take the advice of those who’s basic economic theory either ignores finance or reaches the conclusion that finance doesn’t matter with the proverbial grain of salt.

As a result of financial linkages economists are recognizing that capitalist economies are best modeled as complex non-linear time dependent systems then it follows that the path through time of capitalist economies are likely to exhibit periods of incoherence, of instability that is due to the characteristics of the system rather than to any inept or malevolent shocks.  

There are many different financial structures in history, in existence and in our ability to invent. These different financial systems have different impacts not only upon economic efficiency and stability but also on the distribution of power in the economy. Therefor there are choices that need to be made, options that need to be considered.

THE SURPLUS AND FINANCE.

4. It is well known that multidimensional non linear time dependent systems are almost certain to generate complex time paths. If economies are modeled as such systems then fully endogenous incoherent behavior will take place. In such models runs of coherent behavior are the result of interventions and constraints. The floors and ceilings business cycle models of some 30 years ago can now be generalized. For an exposition of the economics of chaotic systems see Baumal and JEL 1989.

For floors and ceilings business cycle models see JR Hicks and HP Minsky "Monetary Systems and Accelerator Models" AER 1957 and HP Minsky "A Linear Model of Cyclical Growth." RE STAT 1959
In any economy where investment takes place - or where there is a court, an army, a priesthood or production for the use of foreigners - the total of wages paid is greater than the wages paid in the production of the goods the wage earners will buy. Put it simply the workers producing investment output or who serve the person of the Prince have to eat. As a result the price of the goods wage earners buy is greater than the labor costs in producing these goods. This elementary relation indicates that there will be a surplus: gross profits will be earned in the production of consumer goods and these profits will depend upon the relation between the total wages paid for the production of consumers goods and the total wages paid in the production of investment goods.5

In a capitalist economy the surplus that is created is forced by investment spending takes the form of profits. Capitalism is characterized by two phenomena that follow from the financial system: the allocation of the gross profits of the economy among claimants and the financing of spending so that the composition of demand generates a surplus, results in profits.

At the level of the individual unit and the particular financing deal the financing of investment takes place

5. For a further explication of these relations see M. Kalecki, D. and S. J. Levy, and H. Minsky STABILIZING AN UNSTABLE ECONOMY,
because a pro forma (a projection of revenues and costs, of cash flows) convinces the business man and the financier that the project will be profitable. The business man answers the financier's question "How will you get the monies to meet the obligations to pay you are accepting?" by pointing to the prospective cash flows.

Assumptions about future economic conditions underlie these pro formas. When the construction and land development deals that have undone the S&L's in the United States were entered upon a not unusual assumption was that oil was heading towards ninety dollars a barrel. A bankers cliche is "I've never seen a pro forma I didn't like.", i.e. those seeking financing always present a favorable view of what will take place. In the business of capitalist financing it is the duty of the banker to be the skeptic. One suspends disbelief when one goes to the theater, but one does not suspend disbelief in the board room where financing decisions are made.6 If the aggregate economic conditions that were assumed in the pro formas of 1980 were being realized in 1990 there would be no S&L debacle.

The financial system of a capitalist economy allocates the realized surplus to individual claimants - creating interest, dividends and retained earnings incomes. It also uses the financial system to finance investment, government deficits, export surpluses, and consumer spending in excess

6 I wish to cite what I call William Janeway's first law, "Entrepreneurs lie." Minsky's corollary is "Banker's also lie."
of income. The operations of the financial system finances demands that force a surplus out of the economy. Financed investment, financed government deficits, financed trade surpluses and financed consumer spending in excess of consumer incomes forces the surplus which takes the form of money flows that may or may not be large enough to validate claims to income that are legacies of past financing decisions.

I state these elementary truths in order to make the point that a financial system needs to be created as a socialist economy becomes a market economy. However the revolution is so profound and so wide that it is impossible to create reasonable or believable pro formas, to project future profits, for either existing enterprises let alone for new projects. This implies that the financiers will be required to make great leaps of faith, which in the light of the continuing problems with the recent leap of faith in Latin America seems unlikely, or that the financing of investment will be based on considerations other than the acceptability of pro formas. Financing, whether domestic or foreign, in the absence of acceptable pro formas will depend upon political considerations. The political considerations will either be domestic, which implies a socialization of the investment process\(^7\) or they will be foreign, which

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7. This phrase consciously echoes Keynes.
implies a dependency status for the newly emerging economies.\textsuperscript{8}

\textsuperscript{8} As a result of the great collapse of the financial system between 1929 and 1933 believable pro formas were not forthcoming from private business for sufficient investment to generate a close approximation to full employment. Keynesian deficit financing was a substitute for private investment in both generating income and forcing a surplus (profits) on the economy. Government guarantees of private financing was another way to generate acceptable pro-formas so that private financing of investment took place. The seeds of the 1990's S&L debacle which rest upon government guarantees of private financing were planted in the 1930's.
FINANCING SYSTEMS

There are great differences in the financial systems of the various capitalist economies. Furthermore the financial system in any economy at any time differs from the financial system of the same economy at an earlier or a later date. Financial systems of capitalist economies evolve in response to perceived profit opportunities in financing and refinancing businesses and in adjusting portfolios. Financial innovators are profit seeking business men and financial innovation is an endogenous phenomena. Even without the prompting of Professor Schumpeter J. P. Morgan well understood that the acquisition of market power was the way to acquire assured profits if the macro economies were such as to generate adequate profits. As a result of the impact of the financial systems of capitalism upon the decisions that can be implemented, the actual operations of a capitalist economy differs from the that of the models developed in the formal theory, where the analysis is carried out abstracting from the existence of money. Theory that abstracts from money and finance, such as Arrow Debreu, Arrow Hahn and even the scribbling of


10. Joseph Schumpeter "THE THEORY OF ECONOMIC DEVELOPMENT" Harvard University Press 1936 is the classic English translation of a volume that had appeared in German some 30 years earlier.
monetarists,\textsuperscript{11} are poor guides for understanding problems involved in the transformation of the hitherto socialist economies into capitalist economies: the analysis which abstracts from money and finance cannot be expected to lead to blueprints for the design of the financial institutions of newly emerging market economies.

The critical problem that the transformation needs to solve is: create a monetary and financial system which will facilitate economic development, the emergence of democracy and the integration with the capitalist world. In this transition the control of property needs to move from the planning authorities to decentralized production units (enterprises) and the objective of managements needs to be the earning of profits in the market.\textsuperscript{12}

The Heinz Company, the well known canner of pickles and purveyor of ketchup used to have a slogan \textit{57 varieties} to describe the wide scope of the products it offered. I used to say that there are as many varieties of capitalism as Heinz had of pickles, and that this very variety of the capitalisms that are in place or which have been in place or which will be put in place is responsible for the resilience

\textsuperscript{11} K. Arrow and G. Debreu.
K. Arrow and F. Hahn
M. Friedman
D. Laidler

\textsuperscript{12} Note that there are models of Socialism in which decentralized enterprises seek to earn the best possible profits in decentralized markets. Oscar Lange "ON THE ECONOMIC THEORY OF SOCIALISM", University of Minnesota Press is the classic statement.
of capitalism. Capitalism is both intermittently fragile and resilient. Even as events show that a particular form of capitalism is a failure— as the great depression showed that small government laissez-faire capitalism was a failure—other forms emerge. Thus the emergence of big government interventionist capitalism in the period leading up to and after the second World War was a response to the failure of capitalism between 1929 and 1933. This form of capitalism had a successful run of about forty years in the United States. The current problems of American Capitalism may be interpreted as the aging of the 1933-36 Roosevelt reformation of capitalism and the futility of attempting to reform that now aged capitalism by returning to the failed model of the pre 1930’s era. European capacitlsm's, where the use of the state for public purposes is in better repute than in the States, may be more successful in the foreseeable future because it is more flexible. Japan is off on a different course of a controlled and manipulated market economy which so far seems to need to sustain its flow of profits by massive export surpluses. Japan’s prosperity may be very fragile, for it seems to depend upon technical virtuosity and strong export surpluses. Given its acquisition of foreign assets Japan has to turn into an import surplus economy if the profit flows of those who owe it money are to be able to sustain the liabilities.

The existence of a wide variety of capitalisms and a wide variety of capitalist financial structures makes the
problem of designing the financial system for the economic order that will form in the newly emerging economies to the east of the common market more difficult. It also makes an understanding of the alternative financial structures which are possible and their likely impact upon efficiency, development and distribution important as we begin to write on the largely blank slate that is Eastern Europe.
BALANCE SHEETS

A fundamental attribute of capitalist economies is that each unit has a balance sheet and these balance sheets are interrelated. The capital assets in the economy, the plants, equipment and land that constitute the basic non human productive capacity of the economy, are one set of assets in these balance sheets. In the early stages of capitalism, before the rise of the corporation and when yeomen or lords owned land and say cattle, the actual real things may well have entered the (implicit) accounts: accounts were more like inventories than balance sheets. But as soon as the operator or the ostensible owner of assets began to finance part of the "position" in assets with financial instruments the simple enumeration of assets had to be replaced with a value of assets. It is convenient to value assets in the same currency as the debts are stated. In a modern capitalist economy such simple private ownership has been replaced with corporate ownership: the proximate owners of capital assets are now corporation. The simple ownership of the capital assets of the economy by individuals or even partnerships, as was true in olden days, has been replaced by corporations with complex liability structures. A complex combination of equity shares, bonds,
mortgages, leases and bank loans finance the control of the capital assets that are needed for production.

In such a modern corporate world the liability side of the balance sheet has to be interpreted as a claim by other units to cash payments: liabilities of one unit are assets of another. The various instruments used to finance the position are dated, demand or contingent claims to the cash flows that the operations of the unit, operations that depend upon the use of the physical assets, generate. The essential time dimension which is an essential aspect of capitalism arises for unless the claims to cash are all contingent, depending upon the performance of the organization that issued the liabilities, the commitment to make precisely defined dated payments are entered upon before the funds are realized. The performance in the present may or may not validate commitments that were made in the past. This intertemporal nature of the financial relations of a capitalist economy is the essential reason why capitalist economies are likely not to behave in a nice equilibrium seeking way and why markets need to be regulated and controlled.

The real assets in the balance sheet of productive units are not liabilities of any economic unit. The liabilities that are used to finance these positions are in turn assets in other balance sheets.

The paper world of financial instruments connects various balance sheets. In simple worlds the liabilities of
production units would be assets in household balance sheets and households would directly receive the payments committed on these liabilities. In modern capitalist economies many balance sheets are interposed between the two ultimates: the firms that are the proximate owners of capital and the household who are the ultimate owners of the wealth of the world.¹³

The simplest intermediary owner of the liabilities used to finance positions in capital assets are banks, which interpose their guarantees between the operator of capital assets and the owners of bank liabilities. The power of this guarantee has been such that bank liabilities became means of payments, became the money of the economy. The holding of bank liabilities were deemed to be a secure and necessary part of the wealth holdings. Because of the ways in which the profit driven creation of the means of payment was able to force surpluses and because of the instability consequences of repudiations of the agreement to make payments by banks, central banks were invented as banking became ever more important in the economy.

Because banks had payment commitments to the holders of their liabilities, good bank management led to banks specializing in the financing of commerce, the movement of finished goods through the production process. The financing of capital assets was left outside the banking system and specialized financial institutions such as the

¹³. There are organizations such as Universities with their endowments who are artificial households.
savings and loan associations of ill repute and insurance companies arose to finance longer term assets. As technology changed the need for longer term financing became more pronounced.

Varieties of Financial Structures.

At present we do not want to do genesis, we don’t even want to do evolution. Therefor we will not examine how the simple structure of direct ownership capitalism, where banks financed commerce and households directly financed the capital asset structure of the economy, evolved not only into the corporate financial form but also into the corporate form where the proximate owners of the liabilities are funds and institutions not households. In order to keep this note to a reasonable size we will describe some of the alternative ways of interrelating balance sheets in complex financial structures that now exist.

We can distinguish among the varieties of financial organizations that are open to the eastern economies as they emerge from the inherited socialist organization. One fundamental aspect of these economies is that because there has not been any private ownership of the means of production the capital assets in the economy - the power generating plants, the factories, the farms and the housing properties do not pass through to capital values that are then assets in household balance sheets - there is now private wealth. Furthermore there is no legitimate way to
create such private claims on future cash flows for it is not possible to impute the creation of these assets to some specific earlier exchange of money today for money tomorrow.

Financial structures of capitalist economies differ in the importance and strength of institutions and markets. An economy with a strong market for primary debts and equities of businesses will have banks that are mainly restricted to short term financing of business and the financing of household positions in primary securities and housing. This structure requires that there be many individually managed portfolios and that households are willing to invest directly in corporations. Households have to believe in the integrity of the corporate structure: the management of corporations are presumably operating as fiduciaries with respect to the stockholders. Some of the turbulence in Wall Street with the leveraged buy outs reflect a feeling that the management was not operating as fiduciaries with respect to stockholders. In this structure banks are restricted to lending operations and they traditionally lent for short terms and typically only for commercial purposes. The market presumably financed the longer term capital.

There are two alternatives to the capital market/commercial banks structure: one is the German Universal Bank and the second is the Italian Public Holding Company. In the German case the equities of private firms are held in title or in trust by the banks and the households own bank liabilities, which may have the characteristics of money.
In the Italian model the equities of operating companies, which are formally organized as if they were private companies, is held by a public "holding company" whose position is financed by borrowing from the market. Both the German and Italian models reflect the thinness of the capital market.

The 1990's model of the market oriented financial structure in the United States has a wide dispersion of claims to capital income - it may be called a peoples capitalism - but a large percent of the claimants to the income and the asset value of the liabilities of firms do not own any significant non-housing assets that are the direct liabilities of functioning economic units. What households own are positions in funds - mutual, pension, trust and insurance. These funds are managed by professional organizations which act in a fiduciary capacity i.e. their income and portfolio policies reflect the fund managers views about the best interests of the claimants. The leveraged buy outs of the past several years reflected the portfolio postures of these managed funds.

With the emerging dominance of the managed money funds in the United States there has been some convergence between the three models. This is reflected in the United States by a proliferation of government endorsements of private obligations.

Because there is no significant private wealth the markets for financial instruments and the potential for
market based financing is weak in the eastern world. The practical choice is between the German Universal Bank and an Italian Holding Company model. If the aim is to create a peoples capitalism by way of pension and life insurance funds then the transition from the inherited Socialism may well be through the Italian public holding company route rather than the German Universal Bank.