Full Employment and Economic Growth as Objectives of Economic Policy: Some Thoughts on the Limits of Capitalism

Hyman P Minsky, 1994*

I. Resonance between 1933 and 1993.

I participated in a Conference on Financing Prosperity in the 21st Century at my home base, *The Jerome Levy Economics Institute of Bard College* on 4-6 March 1993. 4 March was the sixtieth anniversary of the inauguration of Franklin D. Roosevelt as President of the United States. The climactic event of the great collapse of American capitalism was the bank holiday that immediately followed the inauguration: officially the bank holiday began on 6 March 1933. Our conference bridged the sixtieth anniversaries of the inauguration and the bank holiday. The combination of the dating and the topic of our conference made me think of the differences and the similarities between the scene as Roosevelt was inaugurated and as Clinton was starting his term.

In what follows I argue that the problems President Roosevelt faced 60 years ago and the problems that now confront President Clinton resonate. Each inherited a rich but failed economy. In the situation Roosevelt confronted the failure was so great that almost all agreed that something quite dreadful was wrong, although there was no consensus on what the problem was, why it took place when it did and how to resolve the problem.[1]

To date, in the 1980's and 1990's, the American economy and the rich capitalist world have dodged the bullet of a debt deflation and a deep depression, such as took place in 1929-1933.[2] [3] The wholesale bankruptcies, massive asset-price deflation and a collapse of GNP

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[1] Roosevelt was inaugurated on 4 March 1933. Hitler had taken power on 20 January 1933. Newspapers like the Hearst press (which supported Roosevelt in the campaign of 1932) found much to praise in Mussolini's Fascism. Anti- laissez faire ideas, such as President Theodore Roosevelt's New Nationalism, which looked to some form of state capitalism as a means of resolving problems of cyclical instability, insider manipulation of the financial system, growing importance of oligopoly, and the obvious inequality of income distribution, were very much in the air. The Hoover administration had put in place, although they did not do much with it, the Reconstruction Finance Corporation, a government investment bank, which was a key organization in the Franklin Roosevelt variety of state capitalism. Several government financing organizations that still exist, such as the Home Loan Banks and the Export Import Bank, were spin-offs from the RFC.

[2] Debt deflation is the label that Irving Fisher attached to the interactive process among debts, output prices, business cash flows, asset prices and employment which took place over 1929-33 and other great depressions. See Irving Fisher, The debt deflation theory of great depressions, Econometrica vol. 1, October 1933: also see Hyman P. Minsky, debt deflation processes in today's institutional environment, Quarterly Review, Banco Nazionale del Lavorno, vol. 143, December 1982.

[3] But, using a concept attributed to Yogi Berra, the Fat Lady has yet to sing: we may be in the midst of a debt deflation that is being played out on a longer time scale.
The National Bureau of Economic Research tells us that an expansion began in late 1992. As the time of writing (late 1993), the data indicates that the expansion is a sometimes thing: the expansion has been moderate, another dip is possible and the prospects for another set of crises in global financial markets are still alive.

and large-scale unemployment, which, if they occur, would create a consensus about the need for drastic government action, have not taken place as yet, and they may not. Whereas in 1933 the economic environment substituted for the gallows in concentrating the collective mind, the amorphous fear that the current situation breeds has not concentrated the collective mind.

S. Jay and David Levy, my colleagues at the Jerome Levy Economics Institute, diagnose the current situation as a contained depression. Such a depression does not send strong signals that something is seriously wrong with the economy.[4] Because of the ambivalent nature of the signals that a contained depression sends, President Clinton's call for change is not well focused. President Clinton and many in his administration may know that something is wrong but they seem unable to put their finger on what it is.

One thing that is seriously wrong with today's United States economy is that we refuse to accept how rich and potentially productive the economy is. Because we think ourselves poor we are unwilling to use government spending to

(a) achieve and then sustain a close approximation to full employment; and to

(b) create resources which enhance the productive capacity of the economy.

This inhibition against using fiscal powers is due to a combination of unwillingness to acknowledge that we are in fact rich and an unnatural fear of inflation.

What is true for the United States is also true for the other rich economies: they plead poverty and cite the potential for inflation as an excuse for tolerating unemployment.[5]

One way in which the current era resonates with that of the 1930s is that the economies are not living up to the standards that were achieved in the recent past: furthermore, rather simple minded policy interventions that were fairly successful in the recent past are no longer as effective as they were. This attenuation of the effectiveness of policy interventions indicates that the institutional structure has evolved so that the current economy is not a simple replication of recent economies. An implication of the decline in the efficacy of policy interventions is that institutions need to be changed to achieve once again a full employment -resource-creating economy.

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42 months elapsed between the stock market crash in 1929 and the bank holiday of 1933. If the much larger share of government in GNP and the financial system interventions, by which governments prevent the negative net worth of banks, savings institutions and insurance companies passing through to the deposits and other non-equity liabilities, slow the debt deflation process then a debt deflation process, in today's institutional environment may take much longer to develop fully than the 42 months between October 1929 and March 1933. If we take the stock market crash of late 1987 as a triggering event for a possible debt deflation, then the repercussions of this stock market crash may not be fully played out. One aspect of the great depression was that the economy stagnated for many months after the downside movement was contained. The current performance of the rich capitalist economies resembles that of stagnant economies.

[4] S. Jay and David Levy, How to restore prosperity in the United States and overcome the contained depression of the 1990's. Annandale -on - Hudson NY, Jerome Levy Economics Institute, 1992.

[5] The road to full employment would be easier if a concerted effort to achieve and sustain full employment was undertaken by the club of rich countries than if the United States took this path on its own. The United States' full-employment GNP may well be 10% greater than current measured GNP and at full employment incomes the United States' huge trade deficit might well be substantially greater than at present. A cross-the-board tariff of some 10% to 15% would constrain some of the leakage into imports of the stimulus from a full-employment policy and would be a good thing in its own right as a revenue measure.

II. The New Model Capitalism of the 1930s

Between 1933 and 1938, by a process of trial and error, the Roosevelt administration responded to the failure of the virtually *laissez faire* capitalism of the first third of the twentieth century by creating an interventionist capitalism characterized by a thoroughly revised financial system, a greatly expanded government, and increased regulation of the labor and product markets. The reconstructed financial system aimed to constrain speculation and induce a focus on resource creation. Government spending increased the ratio of utilized to available labor and financed resource creation. The regulation of labor and industry aimed to improve the distribution of income and contain private oligopoly power.[6]

The financial reforms of the 1930's reflected the view that the function of the financial structure was to abet enterprise, not to fuel speculation. Compartmentalization and transparency were the principles that guided financial reforms.

Compartmentalization involved the creation of special financing agencies for different economic sectors (housing, rural electrification, agriculture and general business are some examples) as well as restricting the liabilities that these different classes of institutions were permitted to issue.

Transparency established the principle that information about the income and activities of publicly held corporations and transactions on the exchanges of the equity and debt instruments of such companies were to be both truthful and widely available.

Transfer payment schemes were not the main thrust of the New Deal.[7] The welfare state, which substituted transfer payments for income from work and owned property, mainly developed after the 1960s, when the measured unemployment rate began its upward trend.

Direct government employment, offered by project-related job programs such as Works Progress Administration (WPA), National Youth Administration (NYA), and Civilian Certification Corps (CCC), and large-scale public works projects which funded employment by contractors, were the main government income-providing operations in the 1930s.

Able-bodied men and women, as well as youths, obtained income in exchange for work. It became a responsibility of government to provide opportunities for work when the private economy faltered.[8]

Roosevelt inherited a failed and discredited capitalism. A new model capitalism, with an extended set of government interventions in the economy, was put in place. This did not happen in the first 100 days, during which the immediate problems of the acute crisis were

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[6] In The New Dealers (New York: Alfred A. Knopf, 1993), Jordan A. Schwartz argues that the New Deal was largely an exercise in state capitalism, in which the government partook in the creation of financing vehicles for households and private business, the production of infrastructure and the emergence of innovative productions. In Schwartz's view, much of the government's role in resource creation and the funding of innovation was transferred to the military in the era of hot and cold wars. The current need to develop a v post-cold- war institutional structure which facilitates \ resource creation and facilitates the adoption of innovative) products and processes is one way in which the Clinton and the New Deal eras resonate.

[7] Little in the way of entitlements existed; I don't even know if the word had been coined. Two premises: no one will starve in America, and a dole is anathema, led to the made work programs of WPA, CCC and NYA.

[8] In the early post Second World War era buoyant private investment demand and the sustained level of military spending combined with demand for housing led to a close approximation to full employment being achieved, even as the ratio of government debt to GNP fell.

tackled. The new model was mainly put in place in the second half of the first term and the first part of the second term (1935-8). The new model, as augmented by the postwar transfer payments of the welfare state, served the United States well for almost half a century.[9]

III. The Deteriorating Performance

The performances of contemporary capitalisms have deteriorated; they have not broken down. Over the past dozen or so years the new model of 1933-7 has developed ailments that are due to a combination of age and the infusion of laissez faire adulterants into the institutional structure during the decade in which conservative ideologues administered the interventionist economy. An overhaul of capitalism is needed if the low levels of unemployment, the relative price stability, and the readily observed improvement in the standards of living that characterized the first twenty or so years after the Second World War are once again to characterize capitalist economies.

The prat falls and comedy acts of the first four months of the Clinton administration make it seem farfetched to propose that its historic task is to put in place a new model capitalism which would develop programs and institutions which contribute to the creation of human, physical and knowledge resources and to their full utilization (full employment). The Clinton administration needs to focus on policies to achieve full employment and to create resources. It needs to keep the programs simple: the New Deal work projects which were oriented to the achievement of concrete objectives are models for program initiatives.

IV. A Bit of History

The usual characterization of the 1933 bank holiday is that Roosevelt closed the banks. This is not true. By Saturday, 4 March 1933, the day Roosevelt was inaugurated, the governors of some 30 states had closed the banks in their states. Even as Roosevelt was being inaugurated he was informed that the New York banks would not open on Monday, 6 March. The bank holiday was a pre-emptive strike it moved the resolution of the problem of illiquid and insolvent banks and other financial institutions from the financial community to the Federal Government.

The United States bank holiday was the climactic event of a great contraction of the American economy that began in October 1929 and lasted until March 1933 - some 42 months of well-nigh monotonic decline. The decline was both long and deep. In the United States, and the United States was by no means the worst case, output fell by about 33 percent, prices fell by about 33 percent, and the indices of stock prices (the Dow Jones and the Standard Poors) fell by some 85 percent.[10] In the winter of 1932-33 unemployment was at least 25 percent of the labor force: this in a country where one-third of the labor force was in agriculture.

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[9] The social security system was not a large pay-out factor in the economy until the late 1960s and early 1970s when retired workers with 30 and 35 years of employment under social security became common.

[10] In the discussion of the Great Depression in the United States the focus is usually upon the unemployment rate and the fall in output prices. The fall in the indices of equity and of real-estate prices was much greater than the fall in GDP or in output prices as measured by the CPI.
Arthur Miller's play The Price examines the effects through three generations of one family of the fall in the stock market. It is an excellent invocation of the emotional impact of the Great Depression on the previously well-to-do.

Sixty years ago capitalism was a failed economic order. Today, as the countries of the Soviet bloc, including the successor states to the Soviet Union, rush to become capitalist market economies, we must not allow the failure of Soviet communism to blind us to the weaknesses of capitalism. We need to examine:

(a) What attenuated the success of the early postwar capitalism?

(b) Why are the capitalist states now in crisis?

(c) What are the contours of a new model capitalism?

The successful capitalism of the 1950s and 1960s were not the same as the failed capitalism of the 1930s. In essence, the 1930s system was a small-government, gold-standard-constrained and essentially *laissez faire* capitalism. It was replaced by a big-government, flexible-central-bank and interventionist capitalism. As Michal Kalecki and Jerome Levy pointed out, a government deficit is the equivalent of investment for maintaining the profits of enterprise.[11] The big government capitalism that were put in place in response to the great collapse of 1929-33 protect the economy from a severe fall in aggregate profits, such as occurred in the great contraction of 1929-33. This makes the collapse of asset values, which was so critical to the development of the Great Depression, impossible.

The Roosevelt government used a variety of inadequately funded government employment devices to offset the weakness of the private demand for labor. Even though government deficit financing had a positive effect on profits in the mid-193 Os the scale was too small to lift profits to a high enough level to trigger a resumption of private investment. Government spending sufficient to set off the flows of funds that would lead to a recovery of private investment was not achieved until the massive government defense procurement of the late 1930s.

Full expansion from the Great Depression depended upon the recovery of private investment. This required a new financial structure, learning how that financial structure operated, and a regaining of confidence by borrowers and lenders.

Financial reform was an integral part of the new model capitalism that was set in place in the 1930s.

V. Reconstituting the Financial Structure in the 1930s

During the Roosevelt years, the reconstitution of the financial structure was a major policy task and a great deal of argumentation and negotiation took place before the legislation was adopted.[12] It was not until after 1936 that the new financial structure was in place. It was based upon two principles: compartmentalization and transparency.

The financial structure was reconstituted with special financial organizations for specified functions, for housing, for agriculture, for imports and exports, for commercial banking, for investment banking and for deposit insurance. The operations of the publicly traded

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[11] Michal Kalecki, Selected Essays on the Dynamics of a Capitalist Economy (1933-1970) Cambridge; Cambridge University Press, 1971, Chapter 7.
The Jerome Levy argument about the relation between investment and profits is most accessible in S. Jay and David Levy, Profits and the Future of the American Society, New York; Harper Row, 1983. See also Hyman P. Minsky, Stabilizing an Unstable Economy, New Haven, Conn.: Yale University Press, 1986.

[12] Ronnie J. Phillips, The Chicago Plan and New Deal Economic Reforms, Annandale-On-Hudson, NY: Jerome Levy Economics Institute, 1993, details the discussion of banking and financial system reform in the aftermath of the collapse of the financial system over 1929-33.

corporations and the markets in which the trading took place were to be transparent. In addition, the Federal Reserve was reorganized so that the gold standard rules of central bank behavior no longer forced it to be deflationary when prices were dropping drastically and unemployment was high. A government investment bank, the Reconstruction Finance Corporation, was part of the control and support mechanism for the financial structure and for the financing of resource creation: it operated by infusing government equity into transportation, industry and finance.[13]

The financial institutions of the post 1936 era differed markedly from that which broke down between 1929 and 1933. Once in place, this system of 1936 evolved as a consequence of the profit-seeking efforts of the various players. Any institutional structure which sets limits to the self-seeking behavior of economic units will set off reactions designed to evade or avoid those limits. In addition, technological changes impinge upon the profit potential of units in the financial structure in a variety of ways. As a result of institutional and usage responses to constraints and technological changes, the effect upon the operations of an economy of a particular legislated and evolved regime will change. Even though the formal Roosevelt financial structure has largely remained in place since the 1930s, the operating details of the structure, as well as the consequences of the structure for the financing of the capital development of the economy, the portfolios of households and the stability of the economy, have changed.

As households, firms, government units and financial institutions learn how a new legislated financial system works they modify their behavior so that they can best profit within this new structure. In 50 years such changes have led firms to use proportionally less internal finance and new equity issues, and more debt for the financing of investment, even as financial market changes facilitated the greater use of debt to hold positions in existing assets. Over the same time frame, financial institutions changed their portfolios so that private default- possible debt weighed more heavily in the structure of assets, and a general shortening of debt life relative to asset life took place. As a result a once-robust financial system became increasingly fragile: fragility implies an increased likelihood that a small stimulus will lead to large changes; a fragile financial structure leads to an economy that is unstable; that is, more vulnerable to a debt deflation.

No serious threat of a financial crisis occurred between the end of the Second World War and 1968. In 1968 the repercussions in the commercial paper market to the default of the Penn Central Railroad on its commercial paper rudely awakened the complacent Federal Reserve Board of Governors to remember its responsibilities for maintaining the stability of the financial system. Since 1968 the Federal Reserve has been forced on more than one occasion to take steps to abort what it deems to be an embryonic financial crisis arising from a lack of liquidity of some set of institutions or markets.

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[13] The immediate resolution of the banking crisis of 1933 was led by the Reconstruction Finance Corporation which took equity positions in about 50% of the banks that reopened after the bank holiday. The Federal Reserve, which had been created in an effort to control systemic bank failures by supplying liquidity, failed to stem systemic bank failures in the 1930s, when the problem was caused by the erosion of equity due to non-performing assets.

In the savings and commercial bank crisis of the 1980s the Federal Reserve once again was unable to contain the failures and assure the validation of deposit liabilities: the Congress and the Treasury supplied the funds which validated deposits and contained the forced sale of assets. The Federal Reserve is not capable of containing a solvency crisis. A government investment bank/holding company is a useful device if adverse system wide consequences of an epidemic of non-performing assets are to be contained.

The big government capitalism of the 1950s and 1960s succeeded in moderating business cycles because the deficits that big governments ran when income turned down sustained business profits when investment lagged. One significant result of the short and shallow recessions of the 1950s and 1960's was that the market power of unions and large oligopolist firms was strengthened. The strong trade unions, the lack of sustained unemployment and transfer payments abetted the improvement of the lot of those near the bottom of the income distribution.

Inflationary pressures resulted from the combination of higher unit labor costs and the market power of firms.

President Kennedy caught the flavor of the experience of the first two decades after the Second World War in the aphorism "A rising tide lifts all boats." This aphorism has been negated by the experience of 1980s, when the lot of those at the bottom stagnated or deteriorated even though aggregate income measures indicated continued improvement. It seems clear that capitalism can function in a variety of different ways and that preference systems and the technical conditions of production do not lead to a law of distribution.

If capitalism are to be successful in the twenty-first century they are likely to be different from the models with which we are familiar. The new model of Roosevelt showed that Kennedy's aphorism can be true. As a result, the ends that a successful economy needs to achieve include a wider distribution of the fruits of prosperity than was achieved over extended periods of time by the pre-1930s model capitalism.

VI. Why are the Capitalist Economies Now in Crisis?

Reagan and Thatcher tried to overthrow the big government interventionist capitalism that they inherited. In the United States the major substantive economic changes of the Reagan years were:

a) the destruction of the revenue system;

b) the emergence of an economy that was structurally dependent upon the government's deficit financing of a budget that was mainly devoted to transfer payments (including interest on the government's debt) and military spending,

c) a high consumption economy due to the increases entitlements as well as in the inequality of income distribution.

d) the fall in the real wage of a large portion of the labor force

e) a fragile financial system and

f) a rising tide of un and under employment.

After a spurious prosperity, largely based upon

a) an unproductive government deficit,

b) an enormous expansion of the financial services industry and

c) financing schemes that left the country with an excess supply of office structures, highly indebted firms and non-performing assets; the economy of the United States virtually stagnated for some six years.

Furthermore, government spending became even more inefficient as an instrument to create resources, because the high interest rates that were a long-lasting legacy of the experiment in practical monetarism of the Volcker era and the great expansion of the government debt resulted in a huge item in the budget called 'interest on the debt'.

The Reagan-Thatcher-Bush experience constitutes a second failure of the *laissez faire* model. It showed that the *laissez faire* model of capitalism cannot meet the performance standards established in the 1950s and 1960s.

[The Clinton administration is groping towards the invention of a 'new' new. capitalism. This 'new' new model accepts the central tenet of Rooseveltian capitalist, which is that effective capitalism requires a large government sector, but it shifts government spending to financing resource creation and the efficient delivery of those services for which fee-for-services mechanisms for the rationing of access and the recovery of costs are either not effective or carry unacceptable social costs].

VII. Essential Flaws of Capitalism

I have not addressed the questions of what are the flaws that made capitalism a failure in 1933 and again in these days and whether these flaws are the result of attributes of capitalism which are its essential characteristics. One striking flaw of capitalism which was identified by Marx and Keynes is its inability to maintain a close approximation to full employment over extended periods of time. The abysmally low standards of living that now exist within even relatively successful capitalisms are largely side effects of the inability to attain and sustain such approximations to full employment.

Keynes imputed this failure to the fact that capitalism is not merely a market economy: it is also a financial system. A fundamental aspect of capitalism is that there are *two* sets of prices. One set consists of the prices of current output. The second set consists of the prices of assets, both the capital assets used by firms in production and the financial instruments that firms issue in order to gain control of the fixed and working capital they need.[14]

Current output prices carry profits and are the mechanism by which costs are recovered. In the abstract, these prices are keyed to the money wage rate. The price of capital assets and financial instruments are present prices for future streams of incomes. The proximate determinants of these two sets of prices are determined in different sets of markets. As a result, they are capable of varying and they do vary with respect to one another. Markets do not constrain capital asset and current output prices to a constant ratio.

The financial instruments issued by firms are held by households and financial institutions, such as banks, pension and mutual funds and insurance companies.[15] Ever since the corporation became the dominant form of business organization, the liabilities of firms include equity shares as well as debts. The equity shares and some debts of some companies are freely traded on public markets: the market value of these instruments depends upon publicly available information. In practice, the price level of assets in a capitalist economy is an index of the market price of shares and debts.[16]

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[14] See Hyman P. Minsky: John Maynard Keynes, Columbia University Press, 1975 and Stabilizing an Unstable Economy, Yale University Press 1986.

[15] In a modern economy household and government debts exist and are held by financial institutions and directly by households. These other liabilities both complicate the cash flows and offer routes which can either dampen and amplify the effect of the business and financial debt structure on the performance of the economy.
In particular, whereas in a clean (no household debts, no government debts) economy interest income is always a distribution of gross capital income in our in fact dirty economy interest income is also a distribution of wage incomes and a claim on tax revenues.

[16] In principle an index of the market price of existing capital assets is the appropriate index of asset prices to use in conjunction with the index of current output prices, but the information for such an index is not

The reforms of the financial system during the Roosevelt era made transparency the overriding principle for corporate management and the operation of markets where financial instruments are issued and traded. Information about the operations of corporations and of markets on which equity shares are traded was to be freely available.[17]

Other liabilities of corporations, debts to banks and private placements, do not depend upon publicly available information, but rather on negotiation and discovery. Such debts, which are not marketable, can be syndicated among institutions, such as banks, insurance companies and pension funds, which are deemed to be knowledgable about processing private information.

As a result of the security market reforms of the Roosevelt era the law caught up with the fact that modern capitalism is corporate capitalism.

Over the 40-plus months of the great contraction the price level of current output fell by 33 percent whereas the price level of equities on the stock exchanges fell by 85 percent. If the ratio of the prices of old and new capital assets was in the neighborhood of 1:1 before 1929, in 1933 the ratio of old to new was more like 1:4. In 1933 no one would order new investment output when the second hand market for capital assets was full of bargains.

In standard economic theory, prices are the terms upon which alternative goods and services are available. As the theory is set up, all that really matters are relative prices. However, to producers in a capitalist economy output prices recapture wage and material costs and carry profits (gross capital income). These profits enable a firm to pay the interest and principle that is due on debts, and to provide funds for dividends and retained earnings.[18] Inasmuch as debts are almost always denominated in money, to producers nominal prices matter. In the markets where assets, financial and real, are traded, prices reflect present views about future money flows. The market value of a firm is a capitalization of its nominal profits and therefore it is stated in nominal terms.

In a progressive capitalist economy investment outputs are a part of current output. When investment outputs are completed they are assimilated to the stock of capital assets: the investing firm pays the investment producer for the investment good. This payment is made with internal funds (retained earnings), funds raised by the sale of equities, and funds raised by debts, either as borrowings from banks or as the receipts from the sale of bonds. At the moment of purchase the value of a particular investment output changes from being determined by the sales price to being determined by the present value of the future incomes that operating and otherwise using this asset is expected to generate.

In practice, in a modem rich capitalist economy corporations are the principal proximate recipients of capital income or gross profits. A capitalist economy can be viewed as a set of interrelated balance sheets and income statements. There are two ultimates in this

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available. The growth of the holding company form of corporate capitalism means that entire lines of business are sold and bought. The model of the second price level needs to incorporate how the price of such operating businesses are determined.

[17] This freely available information means nothing unless sophisticated and knowledgeable analyses of this data exist. An effective transparent financial system requires security analysts, who distribute their analyses either for a fee or in exchange for the use of the services of their "firms".
The lack of assurance about the integrity of security analysts may be an explanation of the rise of the open ended mutual fund as the proximate supplier of equity and debt assets for households.

[18] Retained earnings are the way the equity base of a corporation grows without recourse to the sale of equity on the public market.

formalization: firms, which own the capital stock of the economy; and households, which own the financial liabilities of other units as assets. Financial institutions stand between films and households. Today, to a large extent, the liabilities (equities and debts) of firms are owned by financial intermediaries of one type or another and the assets of households are largely liabilities of financial intermediaries.

These intermediaries - banks, savings institutions, insurance companies, mutual funds and pension funds to identify the most prominent financial intermediaries - are self-seeking (profit- seeking) institutions. In a modem capitalist economy maximizing behavior is not restricted to households and firms that own capital assets: the entire array of financial intermediaries seeks profits. Each profit-seeking financial intermediary has its own agenda: they are not charitable institutions.

Of these profit-seeking, private-agenda financial organizations, one set plays an exceptionally delicate role in capitalist economies. This set consists of the investment or merchant bankers, who either as brokers, who bring buyers and sellers together, or dealers, who take financial liabilities into their own accounts, act as midwives of company start-ups and the financing of continuing operations. Essentially, these operators have superior knowledge about their customers who need financing (those who have a need for funds) and their customers who need outlets in which money can be placed. They turn this private knowledge of the conditions under which funds are desired and the conditions under which funds are available to their own advantage, even as they perform the social function of selecting the investments that the economy makes.

These financial intermediaries are of critical importance in determining the values attached to capital assets as collected in firms. In a balance sheet the book value of the owner's interest in the firm is the difference between the sum of the values entered for capital and financial assets and the value of debts. Dividing the book value of the owner's equity by the number of outstanding shares yields the book value of a share. However, for the main companies in a large economy, there is a thick market for equity shares and this market value may be less than, equal to or greater than book value. A main consideration in decisions to invest is that the market valuation of the capital assets needs to exceed the supply price of the investment output, with a margin of safety that allows for the riskiness of the project.

One consequence of the introduction of these layers of profit- seeking organizations in the markets which determine the value of financial instruments is that the value of financial instruments, and therefore the value imputed to capital assets, can and does vary independently of the cost of investment outputs. Furthermore, the extent to which internal funds are expected to be available to finance investment depends upon the excess of anticipated cash flows from operations over the amount needed to service liabilities that were issued to finance such acquisitions in the past.

Because the capitalization rate depends upon present views of the future and the value of the secure assets in portfolios, the ratio of market price of capital in firms to the market price of investment outputs can vary. The very structuring of the argument in terms of a demand for investment output that depends upon the capitalizing of future profits and the determination of the supply price of outputs as dependent upon labor costs of producing these outputs ensures that the supply and demand relations would not, in economist jargon, be homogeneous of degree zero in either money or in money wages. The result would also not be independent of the extent to which positions of market power are

capitalized into the price level of capital assets. Thus, a) the capitalist technique of valuing outputs and valuing capital assets; b) the market determination of liability structures; and c) the possibility of sharp increases and decreases in the price of capital assets and financial instruments leads to system-determined increases and decreases in the price of assets relative to the price level of current output. This ratio feeds into the amount of investment financed, which in turn leads to the flow of current profits.[19]

Once current profits fall sufficiently, or the carrying costs of debts increases sufficiently, so that the cash flows earned by operations or from financial assets by highly indebted operations are insufficient to meet commitments on liabilities, then the pressure of the need to validate debts (and for depository institutions to meet withdrawals) leads to a proliferation of attempts *to make positions by selling out positions.* The result can be a sharp fall in asset values. A downward spiral in which investment ceases and profits evaporate can occur: the end result of over-indebtedness can be a great or a serious depression.

Although the obvious flaw in capitalism centers around its inability to maintain a close approximation to full employment, its deeper flaw centers around the way the financial system affects the prices of and demands for outputs and assets. From time to time debts and debt servicing rise relative to incomes, so that conditions conducive to financial crises are endogenously generated. Once such a crisis is triggered a collapse of investment followed by a long-lasting depression, accompanied by mass unemployment, will take place, unless a combination of lender- of-last-resort interventions by the central bank, which sustains asset prices, and enlarged government deficits, which sustain profits take place.[20]

This financial flaw cannot be eradicated from any form of market capitalism in which liabilities exist that are prior commitments of the gross nominal profit flows of businesses. Reforms which constrain the possibility of using excessive debts for specified purposes were part of the new model capitalism of the 1930s. Many aspects of these constraints were rendered ineffective by institutional evolution by the 1980s. In particular, constraints upon the assets eligible for the portfolios of the Savings and Loan Associations were relaxed. The result was a series of crises of financial institutions and corporate indebtedness. A big depression did not happen in the early 1990s because the government validated the debts of the financial institutions that became insolvent, and huge government deficits sustained profits.[21]

The new model capitalisms that emerged out of the Great Depression and the Second World War had much larger government sectors than the failed model of the 1920s. central banks were no longer constrained by the gold standard: they were now expected to use their ability to affect the behavior of banks to sustain income and employment and contain any thrust of the economy to an accelerating inflation or a deep deflation. The ability of a country to float its currency was much greater and the responsibility for maintaining aggregate demand by government and even by international cooperation was acknowledged.

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[19] The relation between the price level of capital assets and current output along with other factors determines the volume of aggregate demand and the excess or deficient demand for labor at the current wage rates. This excess or deficient demand will affect the movement of wages and thus the price level of investment output.

[20] In this view the intervention by a deposit insurance authority to assure that deposits at "protected institutions" are paid at par is a central banking action.

[21] This validation has been called a bailout.

For much of the period in which the new interventionist model worked well, the sole governor of the international system was the United States' commitment to maintain its domestic economy at a relatively close approximation to full employment and its willingness to run a trade deficit. This power of the United States within the world economy has been eroded as it has become a smaller part of the world economy.

Capitalism failed in 1929 because of the flaw inherent in the two-price system nature of capitalism. In the 1930s and after the Second World War capitalism was reconstructed with a much greater government sector, which in the United States was largely devoted to sustaining consumption and military spending. Private investment remained the major determinant of the increase in productive capacity, and the amount of private investment still rested upon the price level of capital assets being greater than the supply price of investment outputs. The flaw in capitalism, that over- indebtedness can lead to a sharp decline in the ability to validate debts and therefore to a sharp fall in the value of capital assets as collected in firms, remained, even though the structure of assets and liabilities in the first two decades after the Second World War did not allow for a debt deflation to occur.

VIII. Recent History

The recent history of the United States is a history of thrusts towards a debt deflation that were contained by a combination of central bank intervention and massive government deficits. The contained depression of the early 1990s first led to a sharp fall in short-term interest rates and, with a lag, by a fall in longer-term interest rates. This fall in interest rates raised the present values of income streams: asset values increased. This rise has abated the turbulence in US financial markets.

The capitalism that failed over 1929-33 was a small government, constrained central bank and essentially laissez faire economy. The capitalism that had a good run after the Second World War was a big-government, interventionist economy with central banks that were less constrained than during the interwar years.

The post-Second World War model of capitalism was so successful over the first twenty-plus years after the war that some are given to calling that period a Golden Age. In truth, it was not a Utopian Golden Age, for each of us can find fault with some details of the economy of the 1950s and 1960's. But that performance might very well be a practical best. On an absolute scale, the most recent twenty-plus years after the Second World War have not been bad, but they suffer by comparison with the early postwar period, However, a clear path of deterioration is discernible over recent years, in part because of policies such as those which Reagan and Thatcher exemplify, in part because of the way in which protracted success led to an acceptance of commitments to pay which erode the margins of safety that make capitalist firms and financial institutions resilient.

The junk bond episodes and the commercial construction excesses are built into the way in which business people and bankers interact in a capitalist economy. Only capitalist economies in which the regulatory agencies have stronger and more sophisticated controls than those of the regulatory agencies in the United States can avoid the financial excesses that bring financially complex economies to the brink of collapse.

IX. Dimensions of the Crisis in Policy

'Why are the welfare states of post-Second World War capitalist economies now in crisis?' is the fifth question. I can answer for the United States. The social security system, which is the keystone of the welfare state in the United States, was never adjusted for the enormous

increase in life expectancy over the past 60 years. If life expectancies now were as they were 60 years ago there would be no crisis in the social security part of the United States' welfare state. The solution to this is rather simple: increase the age at which people retire. However, this would increase the labor force. Therefore, there is a need to increase the number of available jobs.

Another problem of the welfare state in the United States is with what is called 'welfare'. This system, aid to families with dependent children (AFDC), provides cash and in-kind support (medical care, housing and food subsidies) to families with children, if income from work or assets is not available to support the children. In practice, a significant part of the population that is welfare-dependent is seemingly locked into a pattern of dependency: women who were raised by recipients of AFDC have children who in turn are being raised by a woman on AFDC. This welfare problem is increasingly viewed as a disaster in terms of the well being of the recipients. However, the alternative to welfare is work for the mother and child-care for the children.

Welfare reform leads to a similar problem as social security reform. To have people who are now on welfare or on social security entering the labor force increases the demand for jobs. The problems of the welfare state in the United States stem from the inability to achieve and sustain tight full employment.

We now live in a world where less than 3 percent of the United States' labor force is in agriculture and where a decreasing percentage of workers can produce all the standard manufactured goods that the economy demands. There is a need to support more workers in the production of socially useful outputs that are not manufactured goods and where the costs may not be recoverable by any simple fee-for-services arrangement. In the United States military spending, on both weapons and manpower, supported workers whose costs were not covered by receipts based upon fees for services. Taxes and government borrowing raised the funds for these expenditures. There is a need to replace the military use of available resources with other forms of resource use which like military spending, do not depend for their funding upon fees for services.

There is one crisis in the American welfare state apparatus which is different in kind from those in Europe. During the Second World War the United States began job- related health care 'insurance' and job-related supplements to Social Security in the form of defined benefit pensions that were liabilities of corporations. Many corporations also took responsibility for the health care of their retired workers. These pensions were not funded until the 1970s and even now many are only partially funded. These pensions typically are vested after quite a few years on the job and until recently were not portable: workers were tied to corporations which presumably had secure market positions in perpetuity.

Over the past several years a large number of the great corporations of the United States have had serious financial difficulties. Some have gone into bankruptcy and others have downsized dramatically. Firms have taken drastic steps to reduce not only their shop-floor workers but also their overheads. Security of employment in the United States was never as great as in Japan, but it certainly was much greater in the past than it is today.

The newly revealed vulnerability of corporations means that the private-pension and health-care systems of the postwar period are no longer viable. The Clinton administration is attacking the problems of our health-care system. As yet there is no serious attack on the problems of the pension system that supplements social security.

The Clinton administration is a repudiation of the economic and social policies of the Reagan-Bush years. It accepts that there are government functions which are legacies of the past which need to be reconsidered. It denies the conservative assertion about the incompetence of government. The administration also recognizes that programs such as welfare, social security and health care require reformulation.

A big issue as yet not addressed is how is the United States is going to administer the industrial policy, which up to now has been carried in the military budget. The United States still has an unrivalled resource in the depth and wide distribution of research universities: almost every state has one or more usually quite serious establishment. Many of these state universities have strong applied research interests, usually in fields that are closely related to the state's economy. The harnessing of the power to create and invent that such universities have and the transformation of the development arms of the Defense Department into a civilian advanced-project agency, are frontiers that the Clinton administration will have to address as they fully develop an industrial policy.

The end result of the Clinton administration is likely to be a new new model capitalism that uses the model put in place in the 1930s as its point of departure. This new new model will not repudiate nor attempt to dismantle the old new model, which was the aim of Reagan. The new new model of capitalism will explicitly recognize that the achievement of a full-employment economy must come from organizations that are neither typical private corporations nor government departments, as we have understood them in the United States.

Initially, the corporation was a private organization chartered by a special act to carry out a public function. We can expect the new new model capitalism to create corporations which mix private and public funding to carry out programs that have social purposes. We can see glimpses of this in ideas that are being floated for health maintenance organizations, for the development of technologies, and for community development banking. It is not a matter of picking winners in some technological struggle, but rather a matter of defining needs that can be filled with known techniques but which require special organizations to carry them out.

There may well be some experimentation in taxation. The progressive income tax was compromised by Reagan.[22] The argument that consumption is a fairer basis for taxation than income is gaining some following. It is doubtful whether the political courage exists to recognize that the logic of a consumption tax requires that the fair rental value of owner-occupied housing should be entered into the consumption measure used for calculating the tax. However, a thorough and logical consumption-based tax system would simultaneously reintroduce meaningful progression into the tax system and cut through the confusions relating to capital gains and pension schemes.

As was mentioned earlier, pensions are a policy problem due to the American system of a government social security system supplemented by private pension schemes, which in turn are publicly supported by the exemption from taxation of income placed in pension funds, either at the corporate level or at the beneficiary level.[23] Furthermore, the income

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[22] The 1993 tax act improved the fiscal picture but it did not undo all of the harm of the 1980's to the revenue system of the United States.

[23] Whereas placements into pension accounts are to a limit (which is a substantial part of income for almost all) pre tax dollars employees "contributions" to Social Security are of after tax dollars. Symmetry would call for making the "contributions" of employees to Social Security pre tax dollars. Once this is done the reason for

earned by the assets held by pension funds, as well as the portfolio gains, are exempt from taxes until the beneficiary begins to receive a pension from the fund.

X. Conclusion

In a tentative way the Clinton administration is trying to discover the contours of a new new model of capitalism: as yet it is not a conscious quest. But as one item in the menu of unmet needs leads to yet another, and as the administration seeks to define 'the better' the country deserves, a new new model of capitalism will emerge which has as its anchors a commitment to full employment and a partnership of public and private agencies in the development of resources. This new new model will be based upon a more explicit recognition than anything that has hitherto guided policy in the United States that the capitalist market technique of creating resources is flawed in that it is inherently myopic and needs to be permanently supplemented by the long view that government alone can have.

Furthermore, in the complex system of product, labor and financial markets that is a capitalist economy, the market mechanisms cannot achieve and maintain full employment. Institutions which supplement private employment with an open ended supply of jobs are needed for capitalism to be successful.

Capitalism succeeded because it is a system that can take many forms, whereas the Soviet model of communism was unable to change its forms. Once a successful new new model of capitalism is put in place, we can be sure that the success will be transitory. For any model of capitalism that succeeds for a time will have features that constrain short-sighted myopic behavior and it is to the apparent benefit of some economic agents to get around the constraints. As these agents succeed, the efficacy of the a particular structure of constraining institutions and usages to bring about a successful economy will diminish.

Long ago Abba Lerner summed up the view put here as arguing that success brings into play market developments that breed failure. The problem of discovering and putting in place the institutions of a successful capitalism cannot be solved once and for all. Success of a capitalist economy is transitory. A future generation will have to confront the problem of turning the new new capitalism into an even newer model capitalism.

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exempting social security payouts from taxation vanishes.