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Stabilizing an Unstable Economy: The Lessons for Industry, Finance and Government

Hyman P. Minsky Ph.D.

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Weltwirtschaft und unternehmerische Strategien

Wirtschaftspolitik im Spannungsfeld zum Innovationsprozeß

HERAUSGEBER: KARL AIGINGER

GUSTAV FISCHER
VERLAG
STUTTGART

ÖSTERREICHISCHE
INVESTITIONSKREDIT
AKTIENGESELLSCHAFT

ÖSTERREICHISCHES
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Prof. Hyman P. Minsky, Washington University

Stabilizing an Unstable Economy: The Lessons for Industry, Finance and Government

I. Introduction

The most important economic event for the United States and the capitalist world of the now forty years since World War II is something that did not happen: There has not been a deep and long depression. As I read the history of the era between the Napoleonic Wars and World War II, recessions – or depressions – that were both deeper and longer than anything we have experienced since 1946 – were common. In this view the Great Depressions of 1929–33 is not an anomaly, it is the culmination of a progression of depressions.

If we take a broad view of the first era of industrial capitalism – from the end of the Napoleonic Wars to World War II – the normal path of the economy seems to be cyclical. The *Hard Times* of which Charles Dickens wrote were normal events. What growth occurred seemed to be a by – product of the business cycle. If we take a similar view of the years since World War II (a "second era" of industrial capitalism) the normal path of the economy seems to be growth. It is possible to construct plausible explanations of the cyclical experience since 1946 by referring to specific policy errors or outside disturbances or shocks.

The dictionary definition of plausible is seemingly or apparently valid. One of the synonyms of plausible is specious. In what follows the equilibrium plus disturbance (or shock) explanation of experience is not accepted. What is advanced is an "endogenous incoherence plus policy interventions and institutional constraints" view. This alternative view emphasizes that a modern capitalist economy is inherently unstable *but* is constrained to the cyclical paths of experience by an analogue to floors and ceilings. In the most recent period of turbulence – 1965 to date – in the U. S. the constraints have been central bank policies and the way in which the deficits that big government generates during recessions stabilize profits.

Success in containing the thrusts to deep recessions affects the perceptions of risk, the values of assets, and the acceptable liability structures for financing asset holdings. This means that success opens the system to evolutionary changes that can undermine the efficacy of the policy regime. There is an aggregate analog to moral hazard in the way subjective evaluations of risk are affected by the success of an economy. As a result the past is only a conditional guide to the future.

Entrepreneurship is one subject of this symposium. Because of the post-war experience, entrepreneurs can carry on their activities believing that the aggregate of

profits, from which their particular profits will be drawn, will increase through time. The history of ever increasing aggregate profits was achieved by the success in containing recessions. This success was due to

1. lender of last resort interventions the impact of financial market disruptions on asset prices and

2. the large government deficit which offsets the impact of decreased private investment on profits.

However, success had led to changes in institutions and in the ratio of payment commitments on account of debts to income flows. These changes may make the same set of policy interventions less effective next time they are called into play.

Entrepreneurs are now making their "micro-economic" decisions in a "macro-economic" environment which may well be "exotic". We may be entering upon a *Terra incognita* where the lessons from history and the teachings of orthodox theory are a poor guide for the decisions of both individual entrepreneuers and policy makers.

II. The Contrast Between 1946–1966 and 1966–1985

The growth and cyclical properties of the economy were not homogeneous over the years since 1946 for the United States. The first half of this period can be characterized as an era of largely tranquil growth, interrupted by transitory and mild recessions and short and quickly contained bouts of inflation. During this first half, little in the way of systemic financial disruption occurred.

The second half of this period – which I date from the credit crunch of 1966 – is marked by the reappearance of seemingly systemic financial turbulence and the rebirth of business cycles. In the United States, since the late 1960's, increasing turbulence has been the rule. The amplitude of business cycles, cyclical peaks and troughs of the unemployment rate, and the frequency of central bank interventions as a "lender of last resort" have all increased.

Since 1966, once again, the case can be made that for the United States the fundamental path of the economy is cyclical and that what growth has occurred is a by-product of the cycles. Furthermore, the downside and the inflationary upward movements of the economy seem to have been contained by government and central bank interventions. The cycles, beginning with the growth recession of 1966–67, have been of increasing severity. A progression seems to characterize the recessions; if extrapolation is legitimate the next recession should be more severe than 1981–82.

I date the change of state with the credit crunch of September 1966. This rather mild crisis – it led to a growth recession – which centered around the ceilings on certificates of deposit and the use of municipal bonds by banks to make their reserve adjustment – was the first incident after World War II in which the Federal Reserve acted as a lender of last resort.

Others date the transition in the early 1970's when some of the close correlations between money and activity broke down. Still others mark the break with the shocks of Vietnam and OPEC.

Regardless of where the break date is set, it is clear that the latter part of the post-war period has been much more turbulent than the earlier part. Furthermore over the latter part the activities and interventions by the Federal Reserve System have increasingly been promoted by felt needs to contain and reverse what is viewed as an emerging "incoherence".

Even though the American and the world economy has been much more turbulent over recent decades than in 1946–1966 the main recessions – though of increasing severity – have been quickly contained and reversed. The brevity of the recessions together with the continued openness of the American economy to imports, has meant that the disruptions due to business cycles have not been a barrier to the diffusion of prosperity to countries that are willing and able to compete in the markets of the affluent countries.

Thus, there is no inconsistency between noting that the growth recession of 1966–67 marked a break in the pattern of behavior of the United States, so that cycles became the normal path, and as Dr. Aiginger put in a letter that was part of the process of reaching an understanding about the scope of this Symposium, "that 1966–1973 is assessed as the Golden Age of post-war economic growth in Austria". After all Japan was very hard hit by the first oil shock of 1973, many of the major successes of Japanese industry are developments of the past twelve or so years; the rate of increase of Japanese prosperity has accelerated even as recessions became more severe in the United States. As things now stand, Japanese prosperity is very vulnerable if the next recession is both more severe and more protracted than earlier recessions.

III. Constrained Instability Rather than Equilibrium

The Capitalist economies we are interested in use expensive and long lived capital assets in production and the proximate users of capital assets finance their positions in capital assets by a variety of financial instruments. The actual possessors of wealth typically do not own capital-assets as such, rather they own various financial instruments, which often are claims on financial institutions. There is a vast

and complex monetary and financial structure which interposes a veil between the capital assets of an economy and the ultimate owners of wealth.

Not only does a complex financial structure exist, but this structure evolves as bankers and business men seek profits by innovating in financial instruments, institutions and the burden of liabilities. The past, present and future of a modern economy is reflected in not only an inherited capital stock, a current rate of utilization of capital, and investment programs but also in inherited liabilities, payments now due on commitments undertaken in the past, and new issues of financial instruments that embody payments to be made in the future. Any "days" performance of the economy validates or does not validate decisions in the past even as today's investment and financing decisions set standards to which the future must conform if in the future today's decisions are to be judged as having been correct.

The links between the financial and the production systems of todays capitalist economies are complex, multidimensional, not necessarily additive, and time dependent. Furthermore, the financial systems, the production systems, and the links evolve as business men and bankers seek profits by innovating. The complexity of the integrated system as well as its evolutionary characteristics means that no equilibrium or equilibrium path is likely to exist. Furthermore, even if such a system is well behaved for a while, over time explosive or discordant relations are likely to appear: the system can become incoherent or chaotic.

Although we need to think of an Economy as being capable of chaotic behavior, we rarely observe anything that approximates chaos. There is a need to reconcile the likelihood that the underlying dynamics of a complex system leads to intermittent thrusts towards chaos and the observation that order, or better coherence, is the rule.

In earlier technical studies I noted that explosive dynamic interactions can be constrained to yield nice business cycles by the artifact of positing the existence of floors and ceilings. These floors and ceilings stop the system is internal dynamics and serve as new initial conditions for a resumption of the system's internal dynamics. The relation between the initial conditions and properties of the system's internal dynamics determine whether the system bounces quite rapidly between the floors and ceilings or whether it crawls along either the floor or the ceiling for a while before "taking off" to the other constraint.

This new initial conditional approach to the analysis of dynamical systems yields a rich menu of possible system behaviors. Even better it makes the outcomes in an economy the combined result of the system's internal structure and institutional and policy characteristics. Instead of Laissez-Faire leading to coherent outcomes, coherence results from the internal dynamics being constrained and contained by institutions and policy. However not all policy interventions are coherence enhancing and policy interventions may well be conducive to inefficiencies. The analyti-

cal framework that recognizes that the internal dynamics can lead to incoherence and that policy is required to achieve coherence, opens the way to the consideration of various types of efficiencies, allocational, stability, growth, and distribution.

The need for policy interventions and imposed instutional rigidities has long been recognized in banking. The internal dynamics of the financial system from time to time created apparent incipient incoherence. In these circumstances, the central bank, acting as a lender of last resort, dominates the internal dynamics and makes some asset prices or interest rates different than they otherwise would have been. Bank regulation and examination reflect the not well articulate view that if left along profit seeking bankers would engage in practices that have adverse consequences that stretch beyond the banker and the immediate customers.

In a system with banking and the various trappings of modern finance the view that an economy is an equilibrium seeking system is belied by the way the financial structure has "broken down" from time to time under a wide variety of historical circumstances. As is well known even though the economies of the capitalist world are not performing as well as earlier in the post-war period the overall performance is better than in earlier eras. The greater success of the post World War II era is due to the combined effect of more active and successful lender of last resort interventions and government deficits that serve to sustain profits whenever income generated by the private economy declines: Intervention was proven effective.

IV. The Evaluation of Liability Structures

Liability structures are created a investment and positions in capital assets are financed and refinanced. Liability structures set up payment commitments which are dated, demand or contingent. The commitments are to pay interest, dividends, and for debts, to return the principle. All payments are to be in the medium in which the initial financing took place. For the purposes of these contracts the medium is money. Liability structures are the outgrowth of money now for money later exchanges.

Units with such payment commitments need to acquire the money they have committed themselves to pay. Money can be acquired by:

1. Participating in the production and distribution of gross national product,

2. Borrowing, either *de nova* or by rolling debt over,

3. Selling assets, and,

4. Using cash on hand.

Income from participating in production is the normal way a unit acquires the cash that is needed to fulfill payment commitments. In the negotiations between business men and bankers in which credits are arranged the first question of the banker is "How are you going to repay me?" The answer is in terms of projected cash flows (the gross profits after taxes) plus the receipts from selling out assets. These cash flows and receipts are to be either in the medium of the liabilities or can be exchanged into this medium.

Gross profits after taxes of business is the critical variable in the operation of a modern capitalist economy. Looking backwards, this cash flow determines whether business can or cannot meet the commitments on debts and whether the prices paid *in the past* for capital assets were apt. Looking forward expectations of gross profits are capitalized into the present values of capital assets as collected in organizations, and these expected profits are the information that bankers and business men use in determining the liability structures that an organization can carry.

I have used a three way classification of the cash flow from operations-payment commitment on liabilities arrangements. I have called a structure hedge financing when the payment commitments are met by cash flows from operations, speculative financing when the cash flows are sufficient to pay the principle that is due, and Ponzi financing when cash flows fall sufficiently below payment commitments so that interest is payed by adding to the debt (interest is capitalized). In general an economy is financially robust when hedge financing is dominant and becomes increasingly fragile as the weight of speculative and Ponzi finance increases.

In as much as equity financing involves no need to repay principle and dividends need to be paid only if earned, an economy with little in the way of private debt is hedge financing capital-asset ownership. However, short term financing is readily available on favorable terms in an economy with banking that is mainly hedge financing. This rate structure induces short term financing of long positions. In an economy with banking, financing that requires that debt be rolled over is normal. Experience shows that such financing increases over a run of good times.

In any financing arrangement in which there is a series of payments before income is earned, the folding of interest into to the amount owed is a normal procedure. Any time a major construction project is set up the initial financing involves the capitalization of interest, even though the permanent financing involves payments that can be readily be met out of expected cash flows. What I call Ponzi financing is not necessarily fraudental. But as has been shown many times, the capitalization of interest may lead to debts that are far beyond what expected cash flows can support. A period of Ponzi finance may be part of the path to bankruptcy, and the development of a significant bloc of unintended Ponzi finance is portent of a financially fragile economy.

The weight of speculative and Ponzi finance increases during business cycle expansions and booms and decreases during recessions. If the recessions are mild then there will be an upward trend in the ratio of speculative and Ponzi finance as a result of the way short run finance is linked to the financing of investment.

If investment can be successfully financed by increasing total debt and the proportion of short term debt, then entrepreneurs will be tempted, and bankers may well encourage, the use of similar high debt ratios to acquire existing capital assets as collected in firms. This is now happening in the United States.

The current take over and merger movement in the United States has all the earmarks of a bubble. The increased indebtedness increases the fragility of an already heavily indebted economy. One of the pre-Keynesian explanations of the Great Depression in the United States was overindebtedness. Some of the regulations and constraints that were put in place in the 1930's, which many economists now find hard to understand, were designed to contain the tendency towards over indebtedness. It is not difficult to visualize a recession/depression in the near future that revives overindebtedness as an explanation of deep recessions.

V. The Central Role of Profit Flows

In the economy with business debts, the cash flows to business that enables the commitments on debts to be fulfilled are of central importance. Not only does the fulfillment of commitments keep the debtor credit worthy, but the receipts by lenders supply funds that are available for new loans. The financing capacity of any "today" depends upon the way past debts are being fulfilled. In addition, to use Keynes' felicitous phrase . . . "borrowing and lending takes place on the basis of margins of safety". If non-fulfillment of debts becomes a systemic event, then the margins of safety that both borrowers and lenders require increase. This implies that the amount of financing that will be forthcoming for any equity base profit prospects and financing terms will decrease.

The decrease of financing lowers investment. But the amount of investment is a main determinant of profit flows. Thus, non-fulfillment of commitments on debts, because profit flows fall short of anticipations, tend to lower future profit flows; the market reaction to a disequilibrium tends to make things worse, not better.

Investment is not the only determinent of aggregate business cash flows. Other components of demand can also have a positive effect upon profits. The most important difference between today's economy and the economy as it was prior to World War II is the far larger scope of government. Government deficits tend to increase profits, even as a balance of trade deficit tends to decrease profits.

The stabilization and even the increase of total business profits in recessions is one of the features that distinguishes the post-war experience from earlier times. The development of fiscal postures that assure that a massive deficit will occur whenever there is shortfall of investment has meant that no systemic inability to fulfill payment commitments on debts has occurred. The success in containing recessions during the post war period is mainly due to the way aggregate profit flows have been sustained. Big government capitalism has been successful mainly because recessions have not led to a decline in the aggregate debt validating ability of business. There is a paradox in the political opposition of bankers and businessmen to a system of which they are the primary beneficiaries. The analysis of the determinants of aggregate profits also shows that a deficit on trade account tends to reduce aggregate profits. Countries with the international asset margin that enables them to play an independent role in international finance, which nevertheless support their domestic economy by a balance of trade surplus, are beggering their neighbor; they are sustaining their prosperity by decreasing the prosperity of others.

The analysis that emphasizes the role of profits in generating the cash flows that validate debts and of anticipated profits in generating the demand for investment requires the profit inducing or sustaining spending to be externally financed. The recent inability of the United States to run a balanced budget or a surplus during a period of relative prosperity may mean that the ability to debt finance in the future has been compromised.

VI. Volcker's Regime At The Federal Reserve: The Dominance of Lender-Of-Last-Resort Interventions

Paul Volcker became Chairman of the Federal Reserve Board as the dollar was under siege. The shift to what was called practical monetarism was less a conversion to monetarist doctrines than it was a cover for acting to protect the exchange value of the dollar. The regime of monetary constraint of 1979–1982 not only helped squeeze inflation out of the economy but it also reestablished the dollar's primacy as the international currency of denomination for many transaction and debts. This dollar regime is now threatened by the balance of trade problems of the United States.

Over the seven years that Volcker has been Chairman there has been a large number of "events" in which the Federal Reserve intervened as a lender of last resort in order to keep what seemed to be a crisis triggering event from in fact setting off a crisis. The banking and financial system is a vast and complex structure of payment commitments. A large of the financial transactions at any day refinance positions. A withdrawal of deposits from a bank does not mean that the bank sells as-

sets or decreases its lending. What the bank does is issue new debt; it will buy money in the language used in banking.

A Central Bank mainly operates as a bank. This means that it lends to customers, buys securities in the open market, and guarantees credits. Because of the fractional reserve nature of the banking system the Federal Reserve's acquisition of assets means that the reserve base of the banking system increases.

When the Federal Reserve act as a lender-of-last-resort it refinances a threatened institution or market by engaging in a banking operation – it lends, buys, or gurantees. In complex situations the actual refinancing does not directly involve the Federal Reserve. Over the past half dozen years the number of situations that required extra market refinancing increased tremendously. In the United States the failure of the Continental Illinois bank is the most spectacular case of a lender of last resort intervention, but it may not be as significant as the success in sustaining the savings industry over these years. As the Wall Street Journal of December 10 reported, everytime a financial crisis seems to be emerging the telephone rings at the Federal Reserve.

Lender of last resort interventions have real effects. By preventing the losses of a threatened institution from spreading financing chanels are kept open. The Federal Reserve's intervention kept the Continental Illinois Bank a going concern. This meant that a vast number of clients were able to finance as usual.

VII. The Role of Big Government in Containing Instability

The critical element making for instability is the dual relation between investment and profits and the way in which profit flows validate or do not validate past commitments. Big government, by which I mean a Federal Government that is at least 15 percent of G. N. P., breaks the tight connection between profits and investment; it enables government to readily run a profit sustaining deficit whenever investment tends to fall.

In addition to the profit sustaining aspect of government deficits, a deficit means that the government is feeding its liabilities into the financial structure. Government debt, if it is the debt of a government that is capable of running a surplus from time to time, is a financial instrument with attributes that private instrument cannot have. Government debt is always free of default risk in the currency of the country, and the Central Bank can always guarantee the liquidity of government debt.

In constructing portfolios the various assets are substitutes or compliments. Because of their special default and liquidity characteristics, government debt and privte debts are complementary, in that an increase in the ratio of government

debts in the asset mix will, in time, lead to an increased demand for private financial assets. An increase in government debt will tend to improve the financing conditions for private debtors, including businesses that finance investment.

It is worth noting that banks and other financial institutions increase the ratio of government debt in their portfolios during recessions and decrease the ratio during expansions. Thus, banks and other financial institutions can be said to store up financing during recessions, which they use during a subsequent expansion. Although this substitution in portfolios could take place without a government deficit (as long as there is a large stock of government debt outstanding) banks can become more liquid without other units becoming less liquid when the government deficit is large.

Big government also buys, hires and makes transfer payments. This means that a part of current autonomous demand is not dependent on current business profit expectations.

Government therefore:

1. stabilizes profits,

2. stabilizes portfolios, and

3. directly demands labor (or finances spending that leads to a demand for labor).

In an economy that is prone to endogenously instability big government, a government that is at least 15 percent and possibly in excess of 20 percent of G. N. P., is a blessing when it contains and reverses recessions. It is a curse if the result is inflation, a pattern of spending and taxes that is wasteful or extensive tax avoidance or evasion.

VIII. The Unfortunate Mix: Beveridge and Keynes-Kalecki

There is nothing in the economic theory of either Keynes or Kalecki that points to the welfare state as the way out of the special instabilities that capitalist economies exhibit. The model of the welfare state evolved out of the emergency actions that were taken as the Great Depression forced economic actions and the various efforts to define a better economy for the post-war world. In Britain this took the form of various reports that Beveridge wrote or instigated. The income maintenance-transfer payment approach of the sixties to the poverty problem was consistent with an inadequate aggregate demand diagnosis of the causes of the depression. However, the transfer payment approach as well as the fostering of trade unions involves interventions in the "heart of contracts". The essential point of the Keynesian diagnosis is that there are general conditions that need to be satisfied if aggregate

demand is to be maintained and that these can be satisfied without intervention into specific markets.

Inspite of the deficits that were run between 1933 and 1939 the progress in reducing unemployment was unsatisfactory. The massive expenditures of the war years did succeed in reducing unemployment, and the combination of continued high level expenditures, a maturing welfare state and the high liquid asset and nominal wealth to income ratios in the United States after World War II ushered in a period of quite unprecidented prosperity. The paradox of Keynesian policy is that even though in principle policy is not supposed to intervene in particular markets, the scale of government needed to constrain the instability of the economy, so that deep depressions do not occur, is so large that tax and spending have significant particular product and cost consequences. This means that policy designed to affect aggregate demand has to be examined for its particular microeconomic effects. There is no dichotomy between aggregate demand and microeconomic policy. Concern about the effect of transfer payments on the incentives to work, of industrial structure on the pace of investment and innovation are part of macroeconomic policy.

The Keynes/Kalecki argument that centers around the determination of aggregate profits implies that there is no need for market power to protect the aggregate of profits, all that is required is an appropriate mix of investment inducing and government deficit policies. If aggregate profits can be sustained by policies, then the need for monopoly power to sustain prices and for trade unions to protect wages disappears. It may have been a misfortune of timing that a Keynesian government, sufficiently large to stabilize profits, appeared in an economic environment which tolerated giant and even monopolistic business and policy that promoted effective trade unions.

Although the Keynes-Kalecki analysis points to the need of a big government, it does not require any particular shape to the spending or the taxing programs, except that the deficit should be sensitive to changes in employment and output. One may wish that the expenditures be useful and that the taxes follow some ability to pay criteria, but this is not necessary.

IX. The Lesson From Reagonomics

Reagan has now been President for five years. As a politician he has been very successful. As far as his agenda of economic policy changes he has also been very successful. Ideas of economists abhoring regulation and other facets of government intervention that had seemed beyond the realm of the possible, have become policy. However, these successes must be joined with the seeds for future troubles that unquestionably have been sown during these five years.

The much heralded supply side economics was just a propaganda ruse. The monetarist claim that an announced program of disinflation would lead to a reduction of inflation with a minimal loss of output and at most a short term increase in unemployment was disproven by the length and depth of the recession of 1981–82. The experience with the tax reduction of 1981 has been that a rise in the disposable income of those with high incomes and wealth leads to a rise in consumption spending not to rise in saving.

The main success of Reagan years has been in the reduction of inflation. This is imputed to two phenomena.

1. The rise of the dollar on the international exchanges. This served to put downside pressure on prices, not only by lowering the dollar price of manufactured imports into the U. S. but also by raising the prices, in the various local currencies, of those international products such as oil that are denominated in dollars.

2. The great weakening of trade unions. The decline in the U. S. manufacturing of automobiles and steel has diminished the importance of the industries that served as the vanguard of the improvement of the lot of the blue collar worker in the years following the 1930's. During and since the recession of 1981–82 the workers in these industries have agreed to contracts that involved wage concessions. In newly deregulated industries, like the airlines, pilots and mechanics have agreed to serious wage concessions.

There is no doubt that Reagan's political effectiveness has lowered the tone of the discussion about economic policy. His adamant stand against tax increases in the face of large deficits during the mature stages of this expansion has made it virtually impossible to develop a serious discussion about the structure of taxes and spending.

The Reagan tax proposals of 1981 struck a responsive chord. There was a consensus that too much was being raised by the personal income tax, at least this concensus existed in the Republican constituency. The tax reduction of 1981 compromised the revenue system. As a result of its programmed tax cuts, the deficit remained at depression levels even as the expansion took hold. Because of the deficits of 1981–1985 the total national debt increased by about $ 1,000 billions. This means that the revenues needed for any given spending program and any given desired deficit is now some $ 100 billions greater than would have been needed when Reagan took office. One of the lessons of the Reagan years is that it is quite possible for a country as basically rich and productive as the U. S. to fly in the face of economic rationality for a good while.

X. The Lessons From Keynes And Experience Since 1935

The preface to Keynes' General Theory was dated December 13, 1935, the book is now 50 years old. In the United States the basic reform legislation of the Roosevelt years was in place by the end of the first term, which ran from 1933 to 1937. There is fifty years of experience behind us and fifty years of trying to get a grip on whether Keynes's *General Theory* was truly a revolution in economics. As I mentioned in my comment on Reagonomics the recovery from the recession of 1981–82 can be explained by the power of deficits in a framework where the Central Bank assures that financial system disruptions are contained. Macroeconomic experience of the past five years is consistent with the simplest versions of Keynesian economics.

Keynes' *General Theory* was much more subtle an analysis of the behavior of capitalist economics than the reduction to some simple fiscal policy rules indicate. In the *General Theory* there is an underlying view that the financial system is given to bursts of euphoria, in which asset values and liability structures become uncoupled from the underlying cash flows that productivity generates. This means that the depressions of history are normal functioning events in an economic order where profits are available from speculating on asset appreciation.

Experience over the post war era is consistent with the view that the successful functioning of an economy may so to speak sow the seeds of its destruction. The first twenty years after World War II were remarkable years for the United States. Not only was it an era of on the whole tranquil growth but the benefits of prosperty were widely distributed. The economy could be characterized as affluent, and it was argued that the poverty that remained was not due as much to a flaw in the economy as it was due to the characteristics of the poor. President Johnson's war on poverty was a profoundly conservative program for it found the cause of poverty to be in the poor rather than in the economy.

The prosperity was associated with a steady rise in indebtedness and an erosion of liquidity. By 1966 the asset structure of the commercial banks had so changed that they had to make position by trying to sell municipal bonds.

The so called credit crunch of 1966 marked a barely perceptable change of state of the economy. From that year on with increasing frequency, the authorities had to be concerned about the viability of the financial structure. The Federal Reserve is now very concerned with being a lender of last resort to financial markets rather than just to the banking system.

With this shift in focus with respect to its responsibilities the Federal Reserve cannot use its weapons in order to try to achieve economic performance objectives. It has to be concerned with the financial stability effects of the structure of interest

rats and financial relations. When it acts as a lender of last resort the Federal Reserve is not able to use its powers to guide the overall performance of the economy.

The experience with the financially sensitive economy since the mid 1960's validates those readings of Keynes that emphasize the role of money and finance in his theory. The experience with the welfare state in the United States has shown that the particular shape of the government policies has effects on particular market and prices. The view that it is only necessary to get the macroeconomy right stands in disrepute.

One result of the Reagan years that is most disheartening is that an apparent impoverization is now under way. The deindustrialization process is leading to the disappearance of many of the higher paying industrial jobs that enabled workers to earn "middle class" incomes. As the number of blue collar jobs in firms that share the benefits of market power with their employees decreases, a process in which impoverization that is not the fault of the impovrished is occurring. It is happening in industry and in agriculture.

If there is a big lesson to be learned from the experience of the past fifty years it is that the problem of how to arrange a capitalist economy cannot be set once and for all time. Getting things working right is a transitory situation. The robust financial structure that was the environment for the tranquil expansion disappeared as business. Banking relations evolved towards the fragile end of the financial spectrum. The repercussions of the fragility of the financial structure was contained over the years since 1966 by a combination of government deficits and lender of last resort interventions.

In the United States, we now have massive deficits in the third and fourth years of a business cycle expansion. The points of vulnerability of the financial structure are not only widespread within the United States but are international in scope. One must be concerned the techniques that worked in 1974–75 and in 1981–82 to turn a recession around will not work as quickly and as completely next time.