

Monetary Policy in an Era of Capital Market Inflation

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ABSTRACT

The theory of capital market inflation argues that the values of long-term securities markets are determined by a disequilibrium inflow of funds into those markets. The resulting over-capitalization of companies leads to increased fragility of banking and undermines monetary policy and stable relationships between short- and long-term interest rates, such as that postulated by Keynes in his theory of the speculative demand for money. Moreover, while the increased fragility of banking is an immediate effect, capital market inflation also creates an unstable Ponzi financing structure in the capital market as a whole.

INTRODUCTION

In his first systematic exposition of his theory of financial fragility, written in 1960, Minsky excused a rather sketchy account of the capital (stock) market with the remark that 'only experience will enable us to know if the widespread indirect ownership of equities through mutual funds has increased or decreased the stability of equity markets' (Minsky 1964, p. 195). To the end Minsky's critique of finance remained essentially within a banking perspective, expressed in his 1986 opinion that

'Banks are the central financial organization of a capitalist economy. Once the assets and liabilities of banks are set, the economy's financing framework is largely determined' (Minsky 1986, pp. 318-319)

This author, as a reluctant former banker, would not argue that the view of the financial system that emerges from bank balance sheets is flawed or incorrect. However, in the English-speaking countries on both sides of the Atlantic that have pioneered business finance through capital markets, the banking system does not cover the whole financial system, as it might in the countries of continental Europe where the universal banking tradition is stronger. In the paper that follows, Minsky's analysis of finance is extended to a critical assessment of financing structures in capital markets, in the theory of capital market inflation, Minsky's contribution to that theory, and the relationship of monetary policy with capital market inflation.

1: THE THEORY OF CAPITAL MARKET INFLATION

It is convenient to start where Minsky and his predecessors Keynes and Marx commenced with a critique, however narrow or brief, of political economy*¹. The orthodox theory of finance is largely a more sophisticated version of Walras' theory of the markets for loanable funds (Walras 1954, part V). According to this theory, savings are brought into equilibrium with investment in the market for loanable funds. This equilibrium is supposed to be arrived at and maintained by Walras' usual market-clearing process of announcing, prior to production and exchange, consumption (and by implication saving) and investment intentions until equality between saving and investment is achieved (ibid. pp. 282-3). Since Walras' time, in neo-classical theory, this process has been attenuated so that capital market arbitrage is supposed to occur perfectly and instantaneously, rather than as a process over time. However, perfect arbitrage also means perfect liquidity in capital markets that take no account of gearing. The equilibrium theory of capital markets is therefore not only a poor account of markets operating in real time. It is also profoundly at odds with the operation of Keynesian liquidity preference in the markets for money and finance. (This is further discussed in Davidson 1972 and Kregel 1995.)

1*** This section draws heavily on the Introduction and Part I of Toporowski (1999).

The theory of capital market inflation is a non-equilibrium theory of capital markets. It argues that the actual value of the capital market, by which is meant the market for long-term securities, is determined by the inflow of funds into that market. Most of that inflow is then taken out by issues of securities (bonds) by governments, and a large part of the remainder of the inflow is taken out by securities issued by corporations. The balance is a net excess inflow which forms the liquidity of the market, circulating around in it until it is 'taken out' by an additional stock issue. The net excess inflow therefore determines the value of turnover in stocks and the liquidity of the market. It provides the margin of liquidity in the market that allows it to absorb a modest degree of net sales by financial investors, or rentiers. Stock markets therefore crash not because they are out of equilibrium, but because their disequilibrium has been insufficient to accumulate enough excess net inflows to accommodate the currently desired net sales by financial investors.

The net excess inflow into the capital market determines stock prices: When this inflow increases, brokers faced with rising purchase orders raise prices to induce stockholders to sell and maintain brokers' stock balances. In this situation, turnover and prices rise in the market. Extended over a longer period of time, a growing net excess inflow gives rise to a process of capital market inflation. (This is hinted at in Daykin (1998), p. 32.) However, not all stock prices rise equally or proportionately. Loan stocks (bonds or debentures) with a maturity date on which they are repaid have the value of the stocks on that maturity date fixed by the terms on which the stocks were issued. Usually this is printed on the stock certificate as the nominal value of the stock and the amount that its holder will obtain when the stock is repaid. This clearly indicates to financial investors an eventual value of the stock which cannot be exceeded on that maturity date. With longer term stocks capital market inflation may drive their prices above their repayment or nominal value before they mature. But this 'trading above par' would only be temporary. However, market prices of irredeemable stocks, such as equities (common stocks), are not obliged to return to any nominal value in the future. Capital gains in these stocks are therefore most likely to be sustained and further increased. A process of capital market inflation therefore increases disproportionately the market values of the longer term and perpetual stocks.

Capital market inflation has economy-wide consequences because of the way in which it changes the behavior of all those affected by it. In the first place, it whets the appetite of financial investors for longer-term stocks on which a capital gain may be made, in addition to revenue from dividends and interest. In this way it reduces the liquidity preference of rentiers precisely when the additional money that has caused the inflation is flowing into the market and when an increase in liquidity preference would be necessary to maintain 'equilibrium' in the capital market. Thus

capital market inflation is not only a phenomenon created by disequilibrium. It is also itself profoundly disequilibrating.

For stock-issuing corporations and governments, the increased demand for long-term stocks is a blessing that is only mildly off-set by the dangers of over-capitalization. Corporations find that they can issue equity at lower earnings per share than previously and at a lower cost because their stockholders now obtain and expect capital gains paid by other financial investors in the future rather than by the corporations. Indeed, since pre-tax profits are calculated by deducting interest payments from operating profits, an easy way of making pre-tax profits levitate is by issuing equity and using the proceeds to retire debt. When all the possibilities of such retirement have been exhausted in a given corporation, profits may be further levitated by taking over (acquiring) or merging with another indebted corporation. When the possibilities of acquisition have been exhausted, subsidiaries may be 'deglomerated' and brought to market with new share issues.

In an era of capital market inflation, the productive activities of the modern corporation are therefore incidental to the restructuring of corporate balance sheets and the making of money by buying and selling subsidiaries. In this way, from being a facility in which corporations may regulate their liquidity by refinancing internally-financed fixed capital investments, the capital market comes to absorb the liquidity of corporations and, most notably in the case of share buy-backs, to place that liquidity at the service of further capital market inflation. Capital market inflation thus ruptures any connection between the market prices of stocks and any presumed or expected earnings or profits from any underlying productive capital assets.

For governments, capital market inflation offers new financing opportunities, even as the apparent prosperity of the capital markets makes it the most powerful constituency in the land and effective judge and jury over government policy. The increase in the influence of finance on government, attendant upon capital market inflation, places government fiscal policy under public and hugely critical scrutiny, which may well account for the recent conservative trend of opinion on such policy. Capital markets have traditionally taken a hostile attitude towards deficit financing because of the perceived reduction in the scarcity value of government debt which it entails. However, for governments which have inherited substantial commercial public sector companies, the development of privatization since the 1980s offers a form of deficit financing which does not reduce the scarcity value of government stocks. This is because privatization is a way of financing current government expenditure by issuing stocks which are the liabilities not of the government, but of the companies privatized. While it has been publicised as an exciting, free-enterprise-supporting financial innovation by a cash-strapped Conservative government in the early 1980s, it

was in fact pioneered by John Law with the Mississippi and South Sea Companies in the early part of the eighteenth century. This is further discussed in Toporowski (1998).

With households enjoying the benefits of unprecedented capital gains through household direct ownership of stocks and their indirect ownership through pension, insurance and mutual funds, the only losers in the process are the banks. As noted above, capital market inflation induces the issue of long-term stocks and equity by governments and large corporations to replace debt. This is to the disadvantage of banks because governments and large corporations have traditionally been the best and safest borrowers from banks. The present era of capital market inflation, dating from roughly the mid 1970s has therefore been characterized by a process of bank disintermediation. With the loss of their best borrowers, banks have been forced to develop their lending to more marginal borrowers carrying greater risks: Syndicated lending to developing countries, followed by heavy advances against property (real estate) and latterly financial futures, were accompanied by increased lending to less liquid borrowers, in the form of consumer credit and smaller companies.

This is not necessarily apparent from an examination of bank balance sheets, where additional liquidity has been secured by access to larger money markets in which the big corporations are now lending out their liquidity and by innovations such as securitization, which enables banks to liquidate stronger portions of their loan book. Lending to governments and large corporations still figures in the balance sheets. However, this is not direct lending, but the purchase of government bills and commercial paper in the money markets at rates of discount that offer little or no margin over the banks' own cost of capital. The outcome is that state of incipient financial crisis in the banking system, occasionally breaking into financial distress and collapse, which Minsky identified with financial fragility.

2: MINSKY AS A THEORIST OF CAPITAL MARKET INFLATION

The analysis of capital market inflation given above uses ideas that go back to the early years of this century in the theories of business finance of Thorstein Veblen, (in his Theory of Business Enterprise) and which were independently developed by Rosa Luxemburg (chapter XXX of her Accumulation of Capital) and John Maynard Keynes in chapter 12 of his General Theory. They have in common a view of finance as the dominating characteristic of contemporary capitalism but one which exacerbates inconsistencies in free market capitalism rather than alleviating them, as was argued by Walras and neo-classical economists and, among Marxists, by the followers of Rudolf Hilferding. The most recent and perhaps the most original exponent of this approach to finance

was Hyman Minsky. This section outlines three major elements that the theory of capital market inflation owes to Minsky.

First of all there is the fundamental difference that Minsky identified in his first study (Minsky 1964) between the circular flow of income in the 'real' economy outside the financial system, and the flow of funds inside the financial system. When money is exchanged within the financial system, future claims and liabilities are created. The efficiency of the financial system then depends on the ability of the cash flows of the units operating in that system to cover those liabilities as they become due. If cash incomes cannot cover liabilities, and new liabilities cannot be issued to secure additional money, then financial distress occurs. Because of what Minsky called the 'layering' of claims in the financial system (chains of agents claims backed by other claims), financial distress in one unit can lead to the failure of other units whose claims are that unit's (and each others') liabilities. This is not the case when money circulates in the real economy, where the acceptance of current goods and services against money liquidates future claims (subject to common standards of fair exchange).

Arguably the most significant contemporary instance of such layering is the funded pension system, operating through pension funds but increasingly also through insurance companies and mutual funds (unit or investment trusts), where liabilities to pay pensions to employees have their counterpart in stock market assets whose prices have been inflated by the proliferation of funded pension schemes since the 1970s (see Daykin 1998). Many of these schemes are guaranteed by employers. But the value of their assets (in the U.K. and U.S. mostly equity or common stock) would collapse in the event of any large scale maturity of the pension schemes, when stock market assets would have to be realized to meet liabilities. Such maturity is induced or brought forward partly by falling wage inflation (to which pensions contributions are linked) and rising unemployment in a recession. In addition, the casualization of labour attendant upon the currently fashionable policy of making the labour market 'flexible' breeds a financial insecurity that requires additional liquid savings to ensure the maintenance of consumption. The resulting increase in 'liquidity preference' on the part of workers leads to avoidance or evasion of contributions to pension funds. Minsky's concern for full employment and to stabilize labour income (Minsky 1986, pp. 308-313) is a vital element of any strategy to ward off the incipient fragility of long-term saving whether through pension funds or other intermediaries.

Secondly, there is Minsky's taxonomy of financing structures. Capital market inflation changes the normally speculative financing structure of capital market intermediation, which may be stabilized in a properly managed economy by appropriate Markowitz-type diversification, into

Ponzi financing structures where capital gains depend on sustaining and increasing net excess inflows into the capital market. Because the resulting capital gains have nothing to do with the actual efficiency or effectiveness of the quoted industrial and commercial corporations, the search for such gains by competing fund managers encourages trading on reputation. With this comes a whole apparatus of reassurance, dissimulation and disinformation necessary to evoke sufficient emulation of an investment strategy to obtain the required capital gain for those who initiated that strategy. The notions of market efficiency current in contemporary finance theory are at best an ironic comment on such manipulation of market opinion.

Minsky distinguished between layered financing structures, chains of claims balanced against liabilities in the financial system, and the interdependence of units in the real economy, which requires circular flows of income and expenditure unimpeded by illiquidity or failure to settle liabilities. Because of uncertainty about future cash inflows at the time when future liabilities are entered into under speculative or Ponzi financing, there is nothing to ensure that future cash inflows will cover liabilities. An important corollary of his analysis is therefore that free enterprise in finance needs to be controlled much more strictly in finance than it is in normal commerce and industry. Early on, Minsky argued that, together with Government stabilization of incomes and expenditures in the economy, more generalised lender of last resort facilities were an adequate remedy for financial distress (Minsky 1964, pp. 266-272). By the mid-1980s, Minsky had come to realize that it was not practical or even desirable to have the central bank directly, and the Government indirectly, rehabilitate all Ponzi financing structures by extending credit to them and reflating the economy to raise their revenues. In Stabilizing an Unstable Economy he urged a more selective refinancing through lender of last resort facilities. But he did not propose any criteria on which financing arrangements should be selected for such refinancing (Minsky 1986, p. 327). This dilemma is particularly difficult when an asset price inflation boom, such as the existing regime of capital market inflation, lies at the heart of a tangle of interrelated financing structures. The section that follows examines some of the other aspects of the interaction between capital market inflation and monetary policy.

3: CAPITAL MARKET INFLATION AND MONETARY POLICY

Among the most notoriously pernicious effects of asset price inflation is that it offers speculators the prospect of gain in excess of the costs of borrowing the money to buy the asset whose price is being inflated. This is how many unstable Ponzi financing structures begin. There are usually strict regulations to prevent or limit banks' direct investment in financial instruments without any assured residual liquidity, such as equity or common stocks. However, it is less easy to prevent

banks from lending to speculative investors, who then use the proceeds of their loans to buy securities, or to limit lending secured on financial assets. Loans secured directly, or indirectly, on stock market assets have been an important factor in the collapse of Japanese banks following the fall in stock market prices during the 1990s. As long as asset markets are being inflated, such credit expansions also conceal from banks, their shareholders and their regulators, the disintermediation that occurs when the banks' best borrowers, governments and large companies, use bills and company paper instead of bank loans for their short-term financing. As long as the boom proceeds, banks can enjoy the delusion that they can replace the business of governments and large companies with good, secured lending.

In addition to undermining the solvency of the banking system, and distracting commerce and industry with the possibilities of lucrative corporate restructuring, capital market inflation also tends to make monetary policy ineffective. Monetary policy is conducted by the central bank through operations in banking markets. These are principally the fixing of reserve requirements, buying and selling short-term paper or bills in the money or inter-bank markets, buying and selling government bonds, and fixing short-term interest rates. As noted in the previous section, with capital market inflation there has been a proliferation of short-term financial assets traded in the money markets, as large companies and banks find it cheaper to issue their own paper than to borrow from banks. This disintermediation has extended the range of short-term liquid assets which banks may hold. As a result of this it is no longer possible for central banks, in countries experiencing capital market inflation, to control the overall amount of credit available in the economy: Attempts to squeeze the liquidity of banks in order to limit their credit advances by, say, open market operations (selling government bonds) are frustrated by the ease with which banks may restore their liquidity by selling bonds or their holdings of short-term paper or bills (cf. Kaldor 1982). In this situation central banks have been forced to reduce the scope of their monetary policy to the setting of short-term interest rates (cf. Goodhart 1986).

Economists have long believed that monetary policy is effective in controlling price inflation in the economy at large, as opposed to capital mark inflation. Various rationalizations have been advanced for this efficacy of monetary policy. For the most part they suppose some automatic causal connection between changes in the quantity of money in circulation and changes in prices, although the Austrian school of economists tended on occasion to see the connection as being between changes in the rate of interest and changes in prices (Hayek 1935, Lecture III).

Whatever effect changes in the rate of interest may have on the aggregate of money circulating in the economy, the effect of such changes on prices has to be through the way in which

an increase or decrease in the rate of interest causes alterations in expenditure in the economy. As Minsky recognized, businesses and households are usually hard-headed enough to decide their expenditure and financial commitments in the light of their nominal revenues and cash outflows, which may form their expectations, rather than directly by expectations or optimizing behaviour (cf. Goodhart 1984). If the same amount of money continues to be spent in the economy, then there is no effective reason for the businessmen setting prices to vary prices. Only if expenditure in markets is rising or falling would retailers and industrialists consider increasing or decreasing prices. The notion, made fashionable by the Lucas version of monetarism, that business-men are guided in the setting of prices by their expectations of prices changes elsewhere in the economy, is less practical because it requires businessmen to take a view on developments in the rest of the economy, rather than the state of demand and supply in their market. Because price expectations are only observable directly with difficulty, they may explain everything in general and therefore lack precision in explaining anything in particular. Notwithstanding their effects on all sorts of expectations, interest rate changes affect inflation directly through their effects on expenditure.

The principal expenditure effects of changes in interest rates occur among net debtors in the economy, i.e., economic units whose financial liabilities exceed their financial assets. This is in contrast to net creditors, whose financial assets exceed their liabilities, and who are usually wealthy enough not to have their spending influenced by changes in interest rates. If they do not have sufficient liquid savings out of which to pay the increase in their debt service payments, then net debtors have their expenditure squeezed by having to devote more of their income to debt service payments. In this way, Minsky argued, hedge finance becomes speculative, and speculative finance becomes Ponzi finance and the whole financial system becomes more 'fragile'(Minsky 1986, pp. 209-210).

The principal net debtors are governments, households with mortgages, and companies with large bank loans. With or without capital market inflation, higher interest rates have never constrained government spending, because of the ease with which governments may issue debt or claims against itself. In the case of indebted companies, the degree to which their expenditure is constrained by higher interest rates depends their degree of indebtedness, the available facilities for additional financing, and the liquidity of their assets.

In the previous section it was pointed out that as a consequence of capital market inflation, larger companies reduce their borrowing from banks because it becomes cheaper and more convenient to raise even short-term finance in the booming securities markets. This then makes the expenditure of even indebted companies less immediately affected by changes in bank interest

rates, because general changes in interest rates cannot affect the rate of discount or interest paid on securities already issued. Increases in short-term interest rate to reduce general price inflation can then be easily evaded by companies financing themselves by issuing longer-term securities, whose interest rates tend to be more stable. Furthermore, with capital market inflation, companies are more likely to be over-capitalized and have excessive financial liabilities, against which companies tend to hold a larger stock of more liquid assets (this is further explained in Toporowski 1993, chapter 3, and Toporowski 1999, chapter 1). Moreover, inflated financial markets are more unstable, which has further increased the liquidity preference of large companies. This excess liquidity enables the companies enjoying it to gain higher interest income to off-set the higher cost of their borrowing, and to maintain their planned spending. Larger companies, with access to capital markets, can afford to issue securities to replenish their liquid reserves. Thus the high interest rates from 1989 to 1992, which brought about the end of the 1980s boom in the United Kingdom, had only a marginal effect on companies' expenditures. Their principal anti-inflationary effect was through the reduced expenditure of households which had entered into very large variable-rate mortgage commitments during the 1980s property boom, and small and medium-sized companies financing themselves with debt. Thus capital market inflation reduced anti-inflationary monetary policy to squeezing the expenditure of households and smaller companies.

If capital market inflation reduces the effectiveness of monetary policy against product price inflation, because of the reduced borrowing of companies and the ability of booming asset markets to absorb large quantities of bank credit, interest rate increases have appeared effective in puncturing asset market bubbles in general, and capital market inflations in particular. The inflated Japanese stock and property markets never recovered from the sharp rise in Japanese interest rates in 1991, and rising interest rates were associated with the collapse of the Mexican markets in 1995 and the East Asian markets in 1997.

Whether interest rate rises actually can effect an end to capital market inflation depends on how such rises actually affect the capital market. In asset markets, as with anti-inflationary policy in the rest of the economy, such increases are effective when they squeeze the liquidity of indebted economic units by increasing the outflow of cash needed to service debt payments, and by discouraging further speculative borrowing. However, they can only be effective in this way if the credit being used to inflate the capital market is short-term or is at variable rates of interest determined by the short-term rate. There is no evidence that short-term borrowing has been on a scale commensurate with the emerging market boom, and subsequent crises in it. The way in which high short-term interest rates reduce capital market inflation, and burst asset price bubbles in general, illustrates not so much the efficacy of interest rate policy, as the degree to which capital

market inflation undermines any relatively stable relationship between short-term interest rates and capital markets, such as the one implied by the yield curve, or the one made explicit in Keynes's theory of the Speculative Motive for holding money.

Keynes's speculative demand for money is the liquidity preference or demand for short-term securities of rentiers (financial investors) in relation to the yield on long-term securities. Keynes's speculative motive is 'a continuous response to gradual changes in the rate of interest' (Keynes 1936, p. 197) in which, as interest rates along the whole maturity spectrum decline, there is a shift in rentiers' portfolio preference toward more liquid assets. Keynes clearly equated a rise in equity (common stock) prices with just such a fall in interest rates (*ibid.* p. 151, footnote 1). Arguably, with falling interest rates, the increasing preference of rentiers for short-term financial assets could keep the capital market from excessive inflation.

But the relationship between rates of interest, capital market inflation and liquidity preference is somewhat more complicated. In reality investors hold liquid assets not only for liquidity, which gives investors the option to buy higher-yielding longer-term stocks when their prices fall, but also for yield. During an extended period of high interest rates and liquid financial investment institutions, such as that which has characterised the U.K. and U.S. economies since 1980, short-term financial assets acquire longer-term investment value. This marginalizes Keynes's speculative motive for liquidity. The motive was based on Keynes's distinction between what he called 'speculation' (investment for capital gain) and 'enterprise' (investment long term for income). In our times, the modern rentier is the fund manager investing long-term on behalf of pension and insurance funds, and competing for returns against other funds managers. An inflow into the capital markets in excess of the financing requirements of firms and governments results in rising prices and turnover of stock. This higher turnover means greater liquidity so that, as long as the capital market is being inflated, the speculative motive for liquidity is more easily satisfied in the market for long-term securities.

Furthermore, capital market inflation adds a premium of expected inflation, or prospective capital gain, to the market yield on long-term financial instruments. Hence, when that yield decreases, due to an increase in the securities' market or actual price, the prospective capital gain will not fall in the face of this capital appreciation, but may even increase if it is large or abrupt. Rising short-term interest rates will therefore fail to induce a shift in the liquidity preference of rentiers towards short-term instruments until the central bank pushes these rates of interest above the sum of the prospective capital gain and the rate of interest on long-term stocks. Only at this

point will there be a shift in investors' preferences, causing capital market inflation to cease, or bursting an asset bubble.

This suggests a modest extension to Minsky's Financial Instability Hypothesis. During an economic boom, capital market inflation adds a premium of expected capital gain to the market yield on long-term stocks. As long as this yield plus the expected capital gain exceed the rate of interest on short-term securities, set by the central bank's monetary policy, rising short-term interest rates will have no effect on the inflow of funds into the capital market and, if this inflow is greater than the financing requirements of firms and governments, on the resulting capital market inflation. Only when the short-term rate of interest exceeds the threshold set by the sum of the prospective capital gain and the yield on long-term stocks, will there be a shift in rentiers' preferences. The increase in liquidity preference will reduce the inflow of funds into the capital market. As the rise in stock prices moderates, the prospective capital gain gets smaller, and may even become negative. The rentiers' liquidity preference increases further and eventually the stock market crashes, or ceases to be active in stocks of longer maturities.

At this point, the minimal or negative prospective capital gain makes equity or common stocks unattractive to rentiers at any positive yield, until the rate of interest on short-term securities falls below the sum of the prospective capital gain and the market yield on those stocks. When the short-term rate of interest does fall below this threshold, the resulting reduction in rentiers' liquidity preference revives the capital market. Thus, in between the bursting of speculative bubbles, and the resurrection of a dormant capital market with cheap money, monetary policy has little effect on capital market inflation. Hence it is a poor regulator for 'squeezing out inflationary expectations' in the capital market.

The case of the capital market inflation produced by the establishment of funded pension schemes is different. The sustained inflation of capital markets by immature pension funds can maintain a permanently positive prospective capital gain in those markets, putting this monetary capital market cycle into abeyance if short-term interest rates are not raised even higher to counteract this. Moreover, pension funds' purchases of securities are not financed with credit, but through the contributions of employees and companies. Such purchases are therefore largely immune to increases in the rate of interest. Thus, while capital market inflation weakens the influence of monetary policy on the economy in general, because of the reduced dependence of larger borrowers on bank credit, the inflation of capital markets by pension funds renders ineffective attempts at controlling that inflation by increases in interest rates.

CONCLUSION

Capital market inflation, which lies at the heart of today's era of finance and is the most potent symbol of the revival of private enterprise at the end of the twentieth century, is a rather special case of Minsky's fragile financing structures. It marginalizes Keynes's speculative demand for money. In its present form it has been actuated by the proliferation of funded pension schemes, through pension, insurance and mutual funds, which now own the majority of stocks. These schemes require such inflation to be sustained in order to secure capital gains and to maintain the liquidity of their portfolios. Because they have no short term credit as counterpart liabilities, they are relatively immune to changes in short term interest rates. Meanwhile, capital market inflation undermines the effectiveness of central bank attempts to control the liquidity of the banking system and maintain the effectiveness of the short-term rate of interest as an instrument of domestic economic policy.

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