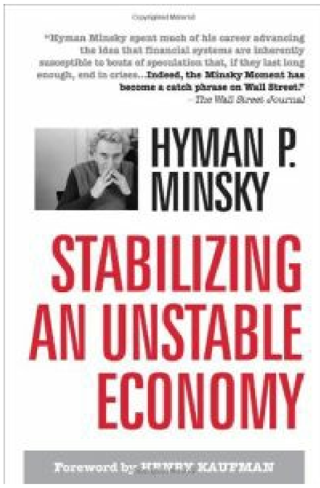

Book Stabilizing an Unstable Economy

Hyman P. Minsky
McGraw-Hill, 2008
First Edition:1986

Recommendation

The late professor Hyman P. Minsky wrote this study of economic volatility in 1986, as an era of frequent economic crises was shaking investors' confidence. His treatise remains relevant today. Minsky doesn't mention dot-com bubbles or subprime mortgages, yet he manages to nail contemporary economic reality. As the economist who lent his name to "the Minsky Moment," that point in time when markets tip from prosperity to crisis, he often repeats his concerns about income inequality, seeming to predict the current debate about ever-increasing concentrations of wealth. But in case you consider labeling Minsky as just a tax-and-spend liberal, consider that he frowns on welfare and long-term unemployment benefits. He's no master stylist as a writer, but Minsky's prose is generally clear enough to reward readers who seek his insight. *BooksInShort* recommends this classic analysis to readers seeking a skeptical perspective on free markets.

Take-Aways

- After 20 years of post-WWII economic stability, the US economy entered a period of almost constant financial crisis.
- Deep recessions in the 1970s and 1980s showed that capitalism is inherently volatile.
- Free markets are the most efficient way to deliver goods and services to meet demand.
- However, free markets fail to foster stability and lead to inequitable income distribution.
- "Big Government" responds to deep recessions with deficit spending and "lender-of-last-resort" bailouts. This stops recessions from becoming depressions but it breeds inflation.
- The neoclassical theory that has come to dominate economic thought is misguided.
- It's right that markets efficiently manage daily supply and demand, but wrong that they alone can handle big issues like income distribution, development and education.
- Indeed, left unchecked, capitalism can create unseemly concentrations of wealth while overgenerous government transfer payments create social instability and inflation.
- Full employment should be economic policy's goal. Employment drives growth. Thus, the US should revive New Deal programs that provided steady but low-paying work.
- At the same time, government should strive for a balanced budget.

Summary

Two Decades of Calm and then, the Storms

In a capitalist economy, bubbles, booms and busts should come as no surprise. Euphoric highs and wrenching lows often shock investors and policy makers, even though such instability is an innate part of capitalism. The 20-year period of stability and prosperity after World War II heavily influenced emerging economic thought by creating optimistic expectations. This tranquil time was the backdrop for the development of a "highly mathematical theory" of economics that downplays the vagaries of risk and uncertainty and the ebbs and flows of financing and investment. The era of stability ended with the credit crunch of 1966, and more financial crises followed in 1970, 1974-75, 1979-80 and 1982-83, each deeper than the last.

> "If the economy provides basic security and a sense of personal worth for all – because work is available for all – many social problems will recede to manageable proportions."

Many economists saw these busts as a repudiation of the macroeconomic theories of John Maynard Keynes and as an affirmation of classical microeconomic thinking. This conclusion is incorrect. To understand today's economy, start with two assumptions: First, free markets offer the most effective way to meet basic economic needs; second, sophisticated financial institutions and massive capital flows, by their nature, overwhelm economies and create instability. Financial meltdowns thus become a familiar part of the economic landscape. In addition to its inherent unpredictability, modern capitalism comes with two other notable downsides: polarizing income inequality and disincentivizing welfare programs. While no scientific principle demands an even distribution of capitalism's benefits, common sense says that the ready availability of jobs and economic security should cure many social ills.

Modern Capitalism

Keynes argued that an economy should strive to achieve "economic efficiency, social justice and individual liberty." In a rich nation like the United States, giving up some productivity to attain the goals of justice and liberty seems a fair trade. However, welfare – in the form of transfer payments – is not the solution. If the poor and unemployed simply rely on transfer payments to survive, the result is both "demeaning to the recipient and destructive of the social fabric." A healthy economy demands that all members earn their own living. A return to post-Depression, New Deal-type employment programs could accomplish that goal.

> "The economic instability so evident since the late 1960s is the result of the fragile financial system that emerged from cumulative changes in financial relations and institutions over the years following World War II."

Given that modern capitalism has become inherently unstable, why hasn't the US economy experienced another Great Depression? The answer lies in the role of "Big Government." The combination of government spending and central bank backstops means that recessions no longer turn into depressions, but they do generate inflation – that's the price society pays for a functioning economy. From 1975 until the early 1980s, inflation never fell below 6%. A series of downturns that generated inflation replaced the business cycle that once experienced depressions on a routine basis.

> "The shape of the business cycle has been changed; inflation has replaced the deep and wide trough of depressions."

Speculation is another result of fiscal instability. In a steadily growing economy, modest but safe returns reward investors who feed the engines of growth and development. In an unstable economy, however, short-term swings in asset prices present the most attractive investment possibilities. The deep recession of 1975 offered the first example of a slump followed by inflation. The 1974 failure of the Franklin National Bank of New York marked the largest-ever bank failure up to that time. More bank failures followed, along with the implosion of the $20 billion real estate investment trust (REIT) sector. A few decades earlier, this crisis would have ended in a depression. But Big Government spending and lending prevented one.

> "Lender-of-last-resort powers provide the Federal Reserve with powerful medicine, but like most powerful medicines, they can have serious side effects."

On the spending side, the federal government ran up big deficits that softened the downturn by boosting incomes and letting borrowers meet their obligations. And on the lending front, the Federal Reserve stepped in as a "lender of last resort" to finance the obligations of borrowers who were teetering on the edge of insolvency.

The Role of Government in the Economy

In some respects, using the phrase "Big Government" to describe the US seems to be a misnomer. While other national governments control health care and own railroads, phone companies and utilities, the US generally eschews ownership of "the means of production." Even so, Uncle Sam is a big spender, dropping cash on everything from wages for bureaucrats and soldiers to contracts for planes and bombs that private companies build. The US government also pays interest on the federal debt and funds Social Security, Medicare and other entitlement programs.

> "We seem to have...a system that sustains instability even as it prevents the deep depressions of the past."

This government-spending machine rolled into action during the 1974-75 crisis and proved the Keynesian premise that federal support could avert a depression. Even under President Ronald Reagan, who vowed to rein in spending, Big Government helped soften the blows of the 1981-82 and 1983-84 downturns. Such spending, of course, sets the stage for inflation. By allowing those without jobs to continue consuming, transfer payments create inflationary pressures in a sputtering economy: Welfare raises disposable incomes and provides upward pressure on wages.

> "In all disciplines theory plays a double role: It is both a lens and a blinder."

Government spending alone can produce a recovery, but only after a painful period of falling corporate profits, dwindling personal incomes and rising unemployment. Big Government funding flattens volatility by propping up asset values. For that reason, it charges the Federal Reserve not only with managing the money supply but also with intervening during crises. Many investors underestimate the importance of the Fed's role as a lender of last resort, but assign near-omnipotence to the Fed's ability to control the money supply and to influence incomes, employment and prices. Yet the Fed's mythical hold over markets is as much perception as reality. Its lender-of-last-resort role is especially important, although it comes with the same downside risk inherent in other government spending: inflation. When the Fed steps in to shore up a troubled investment, it sends a powerful message to investors about the viability of that investment, provokes the assumption that government somehow guarantees the investment and thereby encourages more risk taking. In this way, lender-of-last-resort actions prevent deep, extremely rare crashes, but they also foster short-term booms and busts.

The Folly of Neoclassical Theory

Instability is part of the fabric of market capitalism, yet neoclassical economics attributes no faults to the system. This theory asserts that markets will self-adjust to reach new equilibrium, that instability is just a minor inconvenience, and that periods of high unemployment and crippling inflation are just the way the free market rebalances. In truth, neoclassical economics is flawed: While markets are an efficient mechanism to manage the daily details of supply and demand, society can't depend on free markets alone to answer big-picture questions about income distribution, economic development and education. Indeed, unchecked capitalism can create unseemly concentrations of wealth. But the neoclassicists persist in assigning omniscience and perfect logic to market players with flawed knowledge and suboptimal decision-making skills.

> "The emphasis on investment and 'economic growth' rather than on employment as a policy objective is a mistake."

Neoclassical theory errs in assuming that simple commodities' price movements share the characteristics of sophisticated financial and capital markets. The theory says that rising prices make consumers want less of a product and falling prices make them want more of it. This is how supply-and-demand defines the economic world and it is an accurate description only when tight budgets constrain spending. But in a sophisticated economy, consumers aren't restricted to spending only the cash in their wallets or bank accounts. They also can borrow to support their consumption. The law of supply and demand doesn't really account for the underappreciated role that easy credit financing plays in setting prices. Few of these inconvenient details make their way into neoclassical theory, "the economics of capitalism without capitalists, capital assets and financial markets."

> "Big Government is the most important reason why today's capitalism is better than the capitalism which gave us the Great Depression."

Neoclassical theory also doesn't account for bankers who ignore conventional wisdom. In the '70s and early '80s, the Federal Reserve and the US Treasury bailed out large banks, teaching bank executives that the government would save them even if they made poor decisions. In a modern economy, banks play a crucial role in facilitating investment, but they also are a "disruptive force" that exacerbates volatility. Bankers have selfish reasons to take on risk. They typically start their careers hoping to get rich, but their wealth doesn't derive from salaries; rather, it comes from stock options. To get rich, a banker needs to boost the bank's stock price, and leverage is the surest way to accomplish that increase. Throw in the near-certainty that government will ride to the rescue if risky moves turn sour, and bankers have no reason to play it safe, especially in boom times.

> "The interventions...to protect financial institutions from the life-threatening effects of their behavior have led to an economy that fluctuates...between financial crises and accelerating inflations."

To achieve economic stability, America must incorporate Keynesian theory into its neoclassical orthodoxy. Among the points to consider:

- It's true that free markets work in everyday economic life, but they don't create stability or fairness.
- Complicated financial systems are inherently unstable, and decentralized markets are especially volatile.
- Investors won't put up money for large, long-lasting civic projects without some "protection against market forces."
- In rough economic times, "Big Government capitalism" assures less overall volatility in the business cycle because US federal deficits prop up profits.
- The tax system plays an important role in ensuring the state's ability to support the economy when necessary.
- Big Government can stop recessions from becoming depressions, but the side effect is inflation.
- Full employment should be the goal of economic policy. Employment drives growth.
- Policies that favor investment and economic growth over jobs will create unequal distributions of income.
- Transfer payment programs that are too generous generate social instability as well as inflation.

A Jobs Plan That Works

A look at modern economies reveals two truths: High levels of employment are healthy, and too many welfare and transfer payments are unhealthy. How can the US increase its people's reliance on work and decrease their dependence on government largesse? The answer may lie in reverting to the jobs policies of the post-Depression New Deal. President Franklin Roosevelt used programs such as the Civilian Conservation Corps (CCC), the National Youth Administration (NYA) and the Works Progress Administration (WPA) to provide low-wage jobs to workers who couldn't find employment elsewhere.

> John Maynard Keynes "recognized the flaws in capitalism because he...understood the financial and time-related aspects of a capitalism that uses capital."

A new CCC and NYA would employ people from the ages of 16 to 22, offering them job training while paying them modestly to ease their transition from school to work. For adults, an updated WPA could replace welfare and unemployment benefits beyond 13 weeks, and also could employ those in difficult straits, such as single mothers who need to supplement their Social Security incomes. Together, these three programs could provide jobs to millions of Americans who want to work. Because the CCC, NYA and WPA would pay low wages, they would create little upward pressure on the salaries that private employers pay to attract workers. Indeed, a return to New Deal employment programs would be less inflationary than the current course of sending checks to the unemployed. Jobs in these revitalized New Deal programs would fluctuate with the economy: In tight labor markets, fewer workers would participate, but during financial downturns, the programs' payrolls would swell, as private employers lay off workers.

> "There is no possibility that we can ever set things right once and for all; instability, put to rest by one set of reforms will, after time, emerge in a new guise."

Even as Big Government puts more people to work, it also must put its house in order. A balanced budget is crucial to controlling inflation and retaining the value of government debt. The patterns of federal spending should be clear: After a crisis, government creates deficits to support corporate profits and head off a depression. But as the economy improves and unemployment returns to a predetermined level (such as 6%), deficit spending should then give way to building up surpluses. Of course, tax policy plays an important role in building surpluses, and government should discourage both tax avoidance and tax evasion.

About the Author

Hyman P. Minsky, a student of noted economists Joseph Schumpeter and Wassily Leontief, was a professor of economics at Brown University, Harvard University and the University of California, Berkeley. He died in 1996.