Paul
McCulley

Fed Focus

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Capitalism's Beast of Burden

Over the holidays, I reread Keynes' General Theory of Employment, Interest and Money (1936). Three times. That confession will, I'm sure, trigger more than a few e-mails from friends and colleagues, both old and new, urging me to get a life. And they'll have a point; repeatedly rereading that which has been repeatedly reread could be evidence that the serial re-reader might be half a bubble off plumb.

But there was method in my putative madness: I also reread Schumpeter's Capitalism, Socialism and Democracy (1942), Minsky's Stabilizing an Unstable Economy (1986), and Kindleberger's Manias, Panics and Crashes (1978). And there is no way to fully appreciate these latter authors without a recharged keg of Keynes, from whom all their ideas flow. To be sure, Schumpeter would, if he were still alive, no doubt protest any debt to Keynes, as he was a contemporary of Keynes, and it is difficult for contemporaries to give each other credit for anything.

What is more, nobody on Wall Street would be asking Schumpeter to give Keynes any credit. Schumpeter coined the phrase "creative destruction" to describe the nature of entrepreneur-driven capitalism, and the rediscovery of this clever phrase has lifted Schumpeter to the lofty status of Wall Street's favorite dead economist. Wall Street needed an economic theory to justify paying unsustainable prices for NASDAQ stocks, and found one: Keynes is dead, long live Schumpeter!

What few on Wall Street seem to know is that Schumpeter also believed that capitalism would ultimately morph into socialism, as the prosperity wrought by creative destruction would breed a class of idle intellectuals (yes, Schumpeter's words!) who would stop it. So, we have the odd happenstance of Wall Street celebrating the work of a scholar forecasting the demise of Wall Street. Just adds credence to my long-held belief that many (most?) on Wall Street quote dead scholars they've never actually read!

But enough of that; back to Keynes. And then to Minsky, who **openly** used Keynes' work to develop his "Financial Instability Hypothesis," which provides the best theoretical framework I know for grappling with the current economic and financial markets outlook. As a teaser to get you to continue reading, here's my conclusion on the current economic outlook: **Both Wall Street and Main Street are currently exploding bubbles, and the explosions will self-feed, not self-correct until (1) the Fed eases massively, and/or (2) the federal government proactively reduces the budget surplus.** Hope I got your attention.

Three Seminal Ideas From Keynes

When Keynes published the **General Theory** in 1936, conventional (classical) wisdom held, as he explained, that:

> *"Investment represents the demand for investible resources and saving represents the supply, whilst the rate of interest is the 'price' of investible resources at which the two are equated. Just as the price of a commodity is necessarily fixed at that point where the demand for it is equal to the supply, so the rate of interest necessarily comes to rest under the play of market forces at the point*

NAPM to FOMC: Start Me Up!

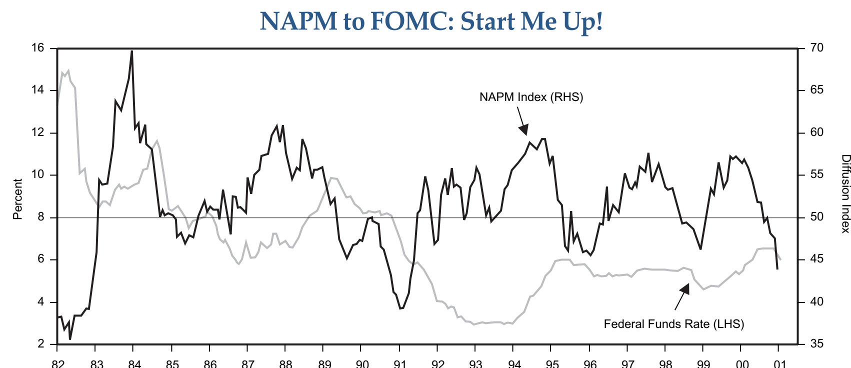

Figure 1

Source: Nat'l Assoc. of Purchasing Mgmt.; Federal Reserve

where the amount of investment at that rate of interest is equal to the amount of saving at that rate."

Keynes argued that this classical interpretation of the rate of interest was correct if, **and only if, one assumed that income was constant.** Which, of course, he maintained was nonsense, if one wanted to understand the dynamic nature of the capitalist economy. The fact that at any point savings must equal investment at some interest rate implied nothing about whether such "equilibrium" was either sustainable or desirable from a macroeconomic perspective. Again, in Keynes' words:

"The traditional analysis is faulty because it has failed to isolate correctly independent variables of the system. Saving and Investment are the determinates of the system, not the determinants. They are the twin results of the system's determinants, namely, the propensity to consume, the schedule of the marginal efficiency of capital and the rate of interest. These determinants are, indeed themselves complex and each is capable of being affected by prospective changes in the others. But they remain independent in the sense that their values cannot be inferred from one another. The traditional analysis has been aware that saving depends on incomes but it has overlooked the fact that income depends on investment, in such fashion that, when investment changes, income must necessarily change in just that degree which is necessary to make the change in saving equal to the change in investment."

This insight from Keynes was essentially the birth of macroeconomics, undermining the microeconomic-driven notion that savings drives investment. Quite to the contrary, Keynes argued: Investment drives income, and income drives savings. Thus, increased investment will beget increased income, which will, in the fullness of time, beget the necessary savings to pay for the increased investment! Powerful, powerful stuff, especially when Keynes was writing in the 1930s; investment and savings equaled each other, as they surely must as a **static** accounting matter, but they equaled each other at a level of national income consistent with twenty-five percent unemployment.

Keynes' breaking of the analytical tyranny of the Saving = Investment tautology was the basis for his advocacy of increased government investment, if private investment was insufficient to increase employment. And, in fact, that's what most of today's investment community knows about Keynes – that man that legitimized illicit, intimate relations with budget deficits! What Keynes actually did was legitimize clear thinking about macroeconomics, as distinct from microeconomics, demonstrating that what holds for the individual need not hold for an economic system. While it can be rational for the individual to increase his/her propensity to save when facing hard times, the collective effect of all individuals trying to do so at the same time will be to ensure hard times!

Yes, Keynes did give savings a bad name, I suppose, but for a good reason. Capitalism, as Keynes' contemporary Schumpeter intoned, is about entrepreneur-inspired investment. More specifically, capitalism flourishes where there is a will for investment. Which brings us to Keynes' **second** seminal contribution to macroeconomic thought: **both the will and the wallet of capitalism are subject to the whims of the human spirit.** First, on the matter of will, Keynes noted:

"There is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. Enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere. Only a little more than an expedition to the South Pole, is it based on an exact calculation of benefits to come. Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but mathematical expectations, enterprise will fade and die; though fears of loss may have a basis no more reasonable than profits had before."

Now we're getting somewhere! Armed with the macroeconomic insight that the **capitalist causal chain** runs from investment to income to savings, not the other way 'round, Keynes enriched his analysis by observing that entrepreneurs are human beings, not a bunch of Adam Smithian invisible hands. Not exactly profound, you say, and you're right. But it is important to understand the straightjacket of the putative macroeconomics of the time, which was really nothing more than classical microeconomics in drag. After all, Secretary of the Treasury Andrew Mellon's advice in 1931 to President Herbert Hoover had been to:

"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. Purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people."

Keynes was simply observing the consequences of Mellon's advice: entrepreneurs who are being liquidated do not have the animal-spirited will to invest! Keynes also observed that they did not have the wallet to invest. Which became the basis of what I consider to be Keynes' **third** seminal contribution to macroeconomics: public capital markets, notably public equity markets, are both a boon and a bane to the capitalist process. Again, Keynes in his own words:

"With the separation between ownership and management which prevails today and with the development of organized investment markets, a new factor of greater importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system. In the absence of security markets, there is no object in frequently attempting to revalue an investment to which we are committed. But the Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to revise his commitments. It is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week.

But the daily revaluations of the Stock Exchange, though they are primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment. For there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased; whilst there is an inducement to spend on a new project an extravagant sum, if it can be floated off on the Stock Exchange at an immediate profit."

Now you know where Tobin found his Q! Investment is not only subject to vagaries in the state of the entrepreneurs' human spirit, but also to vagaries in the state of Wall Street equity speculators' courage. Yes, speculator, as Keynes declared in no uncertain terms:

"If I may be allowed to appropriate the term speculation for the activity of forecasting the psychology of the market, and the term enterprise for the activity of forecasting the prospective yield of assets over the whole life, it is by no means always the case that speculation predominates over enterprise. As the organization of investment markets improves, however, the risk of the predominance of speculation does, however, increase. It is rare, one is told, for an American to invest 'for income;' and he will not readily purchase an investment except in the hope of capital appreciation. This is just another way of saying that, when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favorable change in the conventional basis of valuation, i.e. that he is, in the above sense, a speculator. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

Smart man, that Keynes. He effectively invented the field of macroeconomics, which is founded on the proposition that **what holds for the individual does not necessarily for a collection of individuals operating as an economic system.** This principle is sometimes called the "fallacy of composition," and sometimes called the "paradox of aggregation." But we need not resort to fancy labels to define the common sense of macroeconomics. Anybody who's ever been a spectator at a crowded ball game has witnessed the difference between microeconomics and macroeconomics: from a micro perspective, it is rational for each individual to stand up to get a better view; but from a macro perspective, each individual acting rationally will produce the irrational outcome of everybody standing up, but nobody having a better view.

Minsky Takes Keynes To The Next Level

Hyman Minsky is not a household name on Wall Street. I predict, however, that within the next year, his name will be rolling off tongues like Schumpeter does now. Well maybe not, because Minsky's insight doesn't roll off the tongue like "creative destruction." Rather, his huge contribution to macroeconomics comes under the label of the *"Financial Instability Hypothesis."* Minsky openly declared that his Hypothesis was "an interpretation of Keynes' General Theory." Minsky's key addendum to Keynes' work was really quite simple: **providing a framework for distinguishing between stabilizing and destabilizing capitalist debt**

structures. Here's a concise summary of Minsky's work, written by his own hand in 1992:

> *"Three distinct income-debt relations for economic units, which are labeled as hedge, speculative, and Ponzi finance, can be identified. Hedge financing units are those which can fulfill all of their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit. Speculative finance units are units that can meet their payment commitments on 'income account' on their liabilities, even as they cannot repay the principle out of income cash flows. Such units need to 'roll over' their liabilities – issue new debt to meet commitments on maturing debt. For Ponzi units, the cash flows from operations are not sufficient to fill either the repayment of principle or the interest on outstanding debts by their cash flows from operations. Such units can sell assets or borrow. Borrowing to pay interest or selling assets to pay interest (and even dividends) on common stocks lowers the equity of a unit, even as it increase liabilities and the prior commitment of future incomes.*
>
> *It can be shown that if hedge financing dominates, then the economy my well be an equilibrium-seeking and containing system. In contrast, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy is a deviation-amplifying system. The first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable, and financing regimes in which it is unstable. The second theorem of the financial instability hypothesis is that the over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.*
>
> *In particular, over a protracted period of good times, capitalist economies tend to move to a financial structure in which there is a large weight to units engaged in speculative and Ponzi finance. Furthermore, if an economy is in an inflationary state, and the authorities attempt to exorcise inflation by monetary constraint, then speculative units will become Ponzi units and the net worth of previously Ponzi units will quickly evaporate. Consequently, units with cash flow shortfalls will be forced to try to make positions by selling out position. This is likely to lead to a collapse of asset values."*

Smart man, that Minsky. And also exceedingly prescient. He passed away in 1996, as financing patterns of the New Economy were following precisely his script, moving progressively toward Ponzi units. Beyond that, the Federal Reserve did indeed declare the economy to be in an inflationary state (even if it wasn't!), and attempted to exorcise the (nonexistent!) inflation with monetary constraint. And, lo and behold, the Ponzi finance units have evaporated over the last year, and speculative finance units have morphed into Ponzi units. Risk asset prices have collapsed and, now, **the economy faces the risk of a more generalized collapse of asset values.**

Message to Washington: Print And/Or Give Back Twenties!

Yesterday's 50 basis-point Fed funds rate cut was a very positive signal that Fed policy makers grasp that we're facing a debt-deflation **Minsky Moment**. But that was all it was. The state of both business and household balance sheets is rotten, and the mere promise of monetary reflation will not fix things; monetary reflation **itself** is needed. Put more bluntly, the Fed must turn cash into trash – real short rates must come down a lot, and stay down! And if the dollar goes south along the way, so be it. The objective of monetary policy must be to ease until capitalists **regain their animal-spirited urge to act like capitalists, fleeing liquidity for the hope of capital gains**. Sustainable higher stocks prices and sustainable tighter credit spreads will be the appropriate gauges for determining when enough Fed easing is enough.

And if the Fed delays, or refuses, to explicitly pursue monetary reflation, fiscal policy authorities will have very sound macroeconomic grounds for taking up the charge. Indeed, in the midst of a Minsky Moment, the restorative power of monetary reflation is by definition truncated, so some degree of fiscal stimulus is presently warranted, even if the Fed does vigorously pump the monetary keg. And make no mistake, if fiscal stimulus can be "justified," it will be pursued. As my Washington savvy colleague Bill Powers wisely reminds me, it is actually quite easy to envision a bipartisan competition to see which side can give away more goodies, circa the summer of 1981 (for those of us old enough to remember!).

Debt deflation is a beast of burden that capitalism cannot bear alone. It ain't rich enough, it ain't tough enough. Capitalism's prosperity is hostage to the hope that policy makers are **not** simply too blind to see.

Paul A. McCulley
Managing Director
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Paul.McCulley@pimco.com

PIMCO

840 Newport Center Drive
P.O. Box 6430
Newport Beach, CA
92658-6430
(949) 720-6000

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