Introductory Remarks

26th Annual Hyman Minsky Conference

Jan Kregel (April 18–19, 2017)

I am pleased to welcome you to the 26th Levy Economics Institute Conference on the State of the US and the World Economies. Dimitri Papadimitriou, who as President of the Institute would normally extend this welcome to you, sends his regrets that other obligations prevent his participation but not his best wishes for a lively, open-ended discussion in the tradition of Hy Minsky.

This year's conference takes place in an increasingly charged and divisive economic and political atmosphere. Sharp differences in approach are present within the new administration, within the majority party, and even within the opposition. It is a rather different environment than the one envisaged when planning for the Conference started last September. I had originally proposed as a title "The New Administration meets the New Normal: Economic Policy for Secular Stagnation." It was an obvious attempt to hedge our bets on the outcome of the election. After the election the first adjustment to the title was "Can the New Mercantilism Displace the New Normal: Economic Policy under the New Administration." As you can see the final title eventually adopted the elocution proposed at the presidential Inauguration.

My intention was not to elicit recollection of the "America First" committee's support of isolation from the emerging European conflict in the 1930's. It was rather to recall that the phrase was first used, to my knowledge, by Franklin Roosevelt during his first election campaign.

Herbert Hoover had resolutely refrained from direct government support for the growing masses of the unemployed (although support was more than most give him credit for) for fear of interfering with the operation of the market mechanism in producing recovery from what was presumed to be a temporary cyclical downturn: "Recovery was just around the corner." When this did not occur as expected the blame was laid on foreign financial and political events eroding confidence.

For Roosevelt, Hoover's policy implied that "farmers and workers must wait for general recovery until some miracle occurs by which the factory wheels revolve again" but "No one knows the formula for this miracle." Instead he argued in favour of direct measures to "restore prosperity here in this country by re-establishing the purchasing power of half the people of the country … In this respect, I am for America first."

Instead of the miracle of a spontaneous market recovery, Roosevelt promised to take action to defend the condition of the "forgotten man" by offering him a "new deal" to protect from the ravages of bankers and industrialists. The simple substitution of "America Great" for "new deal" suggests an important similarity between the rhetoric and the target audience of the two campaigns.

It is instructive that in both cases the election was won with promises, creating a belief that appropriate actions would be forthcoming. We know from history how Roosevelt proceeded by experimentation, by trial and error, of what at the time were considered audacious, radical policies.

The question before us today is how the experimentation of the new administration may be directed to fulfill campaign promises.

It was not the specific measures of the "New Deal" (which did not even exist when Roosevelt entered the White House) to restore purchasing power of the farmers and workers, nor was it the organisation by the federal government of the variously alphabetized institutions to implement these measures that were audacious. Rather it was the recognition and acceptance of the fact that the federal government bore responsibility to ensure the well-being of the population. The New Deal thus represented a fundamental change in the role of government as a permanent actor in the economy. In a phrase suggested to Roosevelt by Rexford Tugwell, the role of government was to provide the coordination of economic activity, to produce a reconciliation of diverse individual objectives in a coherent "concert of interests." What Galbraith's gifted pen would call "countervailing power."

This change was not driven by ideology—it is not clear that Roosevelt had one, (although he was religious)—but was based on the recognition that the economic structure that had emerged from the first war was no longer comprised of independent individual producers competing in free markets, but rather one of increasingly large corporations who dominated markets through Schumpeterian innovation producing monopoly power as the normal state of affairs. In difference from Teddy the Trustbuster, and the progressive movement, the New Deal recognised the crucial role of the organisational ability of big business in increasing productivity, as well as the need to channel it to improve the conditions of the working man.

Acting according to individual interests no longer guaranteed the greatest good for the greatest number, since the price system in competitive markets no longer was the basic principle of organisation and distribution. The problem was how to ensure the organisation of the new productive structure to achieve socially and politically acceptable results. The driving force here was more Veblen than Keynes, although it is perhaps easier to understand the point in terms of the circular flow charts that were common at the time: firms' labour costs are the source of firms' sales. The government was no longer to be the disinterested referee of classical liberalism, but would have to become a player to ensure the results promised by innovation under free enterprise.

But, it was not only the changing domestic economic structure that required a reconsideration of the role for government. The New Deal represented the democratic alternative, the "third way" of its time, seeking a political model that avoided both the Fascist and Communist solutions that at the time appeared to be the most successful responses to the Great Depression and had substantial domestic political support. Not only was this role for government radical, because of the international context, but the reference point was with the authoritarian alternatives.

The Conductor's score for the proposed "concert," eventually embodied in the National Industrial Recovery Act, was quickly cast as a "national plan" imposing centralised directives voiding the operation of the free enterprise laissez-faire system upon which the great nation had been built. Indeed, most of the New Deal was built on executive orders creating new agencies to produce regulations designed to coordinate the opposing interests of labour and industry.

What in current discussion is called the "Administrative State," the calls to remove regulations and agencies to liberate free market initiatives were already present in the period. The criticism was thus not of the measures taken in support of the forgotten man, it was the fact that they were taken by the government. It became easy to make the argument against the “pretense of knowledge” rather than recognise the implications in the changed and changing economic structure as the way to avoid the “Road to Serfdom.”

But, as Walter Lippmann pointed out in a book, *The Good Society*, written in the throes of the developing New Deal, this criticism of the New Deal is based on the same error as those liberals who adopt John Stuart Mill’s conclusion that “laissez-faire, in short, should be the general practice: every departure from it, unless required by some great good, is a certain evil.” For Lippmann “The whole effort to treat laissez-faire as a principle of public policy, and then to determine what should be governed by law and what should not be, was based on so obvious an error […] in thinking that any aspect of work or of property is ever unregulated by law […]. In a community there is no such thing: all freedom, all rights, all property, are sustained by some kind of law. So the question can never arise whether there should be law here and no law there, but only what law shall prevail everywhere.”

He goes on to make the point that the defence of regulations to preserve laissez-faire soon impedes freedom since it presumes “the prevailing social order is the only one that can be truly progressive.” The regulations must not be confused with the aim of the “true liberal,” which must be to provide regulation that resolves the social problems created by changes in the productive structure of the economy, by “the whole unresolved task of educating great populations, of equipping men for a life in which they must specialize, yet be capable of changing their specialty” and of providing support for those “who do not adapt themselves easily.”

Thus we can give credit to the new Administration’s campaign for identifying a major problem facing a substantial share of the working population, while at the same time expressing doubts about whether it has recognised Lippmann’s “obvious error” that simply eliminating regulations and reducing the role of government to provide individual freedoms for particular groups could remedy the secular stagnation from which they suffer.

Now we must also admit that Roosevelt was a convinced budget-balancer. Some of you will recall that Ronald Reagan channeled Roosevelt in his first campaign, only to follow Roosevelt’s recantation in creating ever-increasing budget deficits in his efforts to provide for a “sunrise” economy. This is just another aspect of Lippmann’s “obvious lesson” that has not been learned. Reducing the size of government is no more adequate than reducing regulation in achieving the promised objectives. Indeed, the failure of government to take on the responsibility to provide the necessary budget stimulus to support the purchasing power of households in the aftermath of the recent mortgage crisis and in maintaining recovery is one of the major reasons for the secular stagnation that we currently face. The recent recovery is exemplary in being historically slow, but also in which the contribution of federal support has been declining.

And it is important to remember that besides the failure of Hoover's promised "miracle" recovery, there was not only a lack of purchasing power, but the maldistribution of purchasing power, which was a major theme of Roosevelt's campaign.

As noted above, as the campaign progressed, the European financial crises and the decisions of the major European countries to go off gold became more important in explaining the failure of the appearance of the miracle of recovery (yes, the "confidence fairy" was already present in the 1930s). In this regard, note an anniversary that we celebrate today. On April 18, FDR gave his approval to the Thompson Amendment to the Agricultural Adjustment Act (Part 8, Title III – Financing and Exercising Power Conferred by Section 8 of Article I of the Constitution: To Coin Money and to Regulate the Value thereof), which gave the President the ability to take the US off the gold standard, which he eventually did June 5th (Joint Resolution to Suspend The Gold Standard And Abrogate The Gold Clause, June 5, 1933 H.J.Res.192 73rd Cong. 1st Session.) Note the important addition to the powers in the Amendment: the suspension of the gold clause in private contracts. Roosevelt had been careful not to promise to maintain the gold standard, but his pledge to maintain a sound currency was so interpreted, and this action eliminated any support for the New Deal in financial circles, and the suspension clause cemented the belief of those who thought that the President had taken on dictatorial powers.

We finally come to the problem of foreign trade and foreign policy, which was as disputed then as today. Here also the influence of the new structure of production is important, as the interests of agricultural producers seeking foreign markets for their surpluses met the protectionist interests of manufacturing. It makes little difference if the reference is Say's Law, or Smith's bakers and candle makers, division of labour and innovation depend on reciprocity, specialisation imposes mutual dependence – "I shall therefore venture to acknowledge, that, not only as a man, but as a British subject, I pray for the flourishing commerce of Germany, Spain, Italy and even France itself." This is Hume. One of the important aspects of the New Deal “concert” was that the orchestra was composed of foreign as well as domestic players, and while they could not be expected to buy up agricultural surpluses if they could not sell their manufactures in competition with US producers, if all were expanding then all could sell more agricultural goods and manufactures. Clearly, national self-sufficiency is a policy for a war economy, which is a planned economy. Trade restrictions as an attempt to steal purchasing power from foreigners are just as much an imposition on individual liberty as any other type of regulation. To this end we will have two panels dealing with the impact of the modern America first on Europe and South America.

The divisions and disputes that we contend today, and which have contributed much to the current slow recovery, find their source in the failure to recognise Lippmann’s “obvious error” of the blind belief that a reduction in regulation, in the Administrative state, and the role of government will somehow restore a laissez-faire market liberalism that never existed and is inappropriate to the changing structure of production of the US and the global economy. This reflects Keynes’s conclusion in his *General Theory*: “The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes.” These are the areas in which government action is not only appropriate, but necessary, because the tacit assumptions of classical analysis “are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world.” … but “If we suppose the volume of output to be given, i.e. to be determined by forces outside the classical scheme of thought, then there is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them.”

It is interesting that the problems that are faced by the new Administration are so similar to those of the 1930s—lack of sufficient fiscal support to employment, income inequality, and the management of external trade and payments. Those of you who follow the Levy Institute’s publications will note the similarity between this charaterisation of the problems facing recovery from the Depression and those identified in recent issues of our Strategic Analysis. While it would not be appropriate to recommend New Deal policies to the current environment, it would be appropriate to note that the current battle cry of reducing the size of government, of regulation, risks repeating Lippmann's obvious error, by failing to recognise the responsibility of government in dealing with the failure of social conditions to adapt to changing productive structures. In this regard, one cannot resist the opportunity to mention Minsky's proposal for an employer of last resort as a more modern substitute for the New Deal employment-creating measures that provides remedy for both the problems of government's fiscal support and personal employment.

There is one final area of similarity with the experience of the New Deal that it is important to raise. As you know, Minsky was the architect and inspiration of this conference series. In his planning notes for the first conference, which was held in November 1991 under the title "Restructuring the Financial Structure for Economic Growth," Minsky emphasized the importance of structural reform of the financial system as the prerequisite for more sustainable growth and employment. That conference took place in the aftermath of a major real estate crisis that produced considerable changes in the institutional structure of the financial system—some through the purging of unsustainable institutions, and others through regulatory and legislative responses. Minsky's idea was to bring economists from the academy, and professionals and officials facing issues in private finance or in regulatory public policy to the Levy Institute to discuss a new institutional framework. At that time the discussion was centered on the attributes of universal banks relative to bank holding companies and whether it would be appropriate to allow non-financial corporations ownership of financial institutions. Hy contributed to this discussion with a number of policy pieces, most of which were not published, but are available on the Minsky Archive through the Institute's website.

In consulting those papers you will see that Hy, despite my best efforts, was not attracted by the universal banking model. He instead opted for an adaptation of the bank holding company model in which each subsidiary dealing with a particular banking function would be separately capitalised from the holding company itself. This approach has more recently been under discussion in the Vickers report and the idea of what was there called "ring-fencing." Tom Hoenig's recent proposals reflect some of these ideas.

But, Hy's discussion went beyond barriers, to deal with the problem of deposit insurance, suggesting that while insurance might be maintained, it would be most appropriately applied to the asset side of the ring-fenced subsidiary than to its liabilities. He also was in favour of the introduction of community banks and organized a Levy project in that direction. Esther George, who will be speaking this morning, has taken a special interest in this topic.

By the end of the 1990s Hy was no longer present, but the debate on the economy's financial structure was again at center stage, unable to cope with the continuing crisis in mortgage financing created by the disappearance of traditional savings and loan banks and the continuous blurring of the strict Glass-Steagall lines of division between what were commercial banks, in name only, and investment banks, which had encroached on the retail payments system. Banks took on universal functions, but within a holding company structure, absent the separate capitalisation Hy had proposed earlier. We all know the result of this silo-type structure in which it became increasing difficult for managers and regulators to understand the overall risk exposure and the resources available to meet potential losses.

The regulatory response to the failure of this structure has been a push for higher and higher regulatory capital in the hope that there will be enough to cover the resignation that the system will continue to produce ever higher losses. In addition, regulators have imposed liquidity requirements in the form of asset characteristics. But, as Hy, following Keynes, had pointed out long ago, there is no characteristic of assets called liquidity; the ultimate source of liquidity is the ability to convert an asset into means of payment, and this depends on the issuers' access to the regulated banking system and of the banks to the Fed discount window. Unfortunately, in an attempt to shield taxpayers from loss, and constrain Fed independence to act in crisis, Dodd-Frank has sought to limit this crucial aspect of systemic liquidity that has resided in Section 13(3) of the Federal Reserve Act.

But, the most important point is that despite Dodd-Frank the overall financial structure has remained unchanged. I am sure that Hy would have considered this a mistake, noting that the push to higher capital ratios would eventually lead to the equivalent of 100% banking, which would neuter the ability of the financial system to undertake the risky financing that would be required to fund the productive capital structure of the system. I think he also would have noted that liquidity of assets is determined by the willingness and ability of regulated banks to take them on their balance sheets in exchange for more liquid liabilities—100% banks cannot do this. It is interesting that we are now starting to see criticisms, such as in the recent farewell speech of Dan Tarullo, of aspects of the Volcker rule reducing the liquidity of financial markets.

Given that dealer spreads and minimum size are a function of dealer capital this should not be surprising. Higher capital requirements and higher liquidity requirements are in essence mutually contradictory.

So we are back to the initial question that Hy faced: how to change the institutional structure of choosing between the Hensarling emphasis on capital requirements, refining the holding company structure in the Hoenig proposal, or the Warren return to Glass-Steagall. All three proposals are currently in front of Congress. I am sure we will hear further discussion of these issues during the Conference.

As in past years we invite you to take a look or take with you some of our publications available at the desk in the back of the room, and would very much welcome your comments. This year there is an important addition. Three years ago the Institute started offering a two-year Master of Science in Economic Theory and Policy. Last year the first graduating class closed out their year by launching a blog with the title "The Minskys"; you will also find a print of some of their contributions on the desk in the back of the room.

We welcome you. Enjoy the conference. We hope you will find the presentations and discussions thoughtful.

Thank you very much for your attention.