Introductory Remarks

27th Annual Hyman Minsky Conference

Jan Kregel (April 17, 2017)

I am pleased to welcome you to the 27th Levy Economics Institute Conference on the State of the US and the World Economies. This is the last year that I will have to transmit an apology for absence from the President of the Institute. I am pleased to announce that Dimitri will soon return to his duties at the Institute. In the meantime he sends best wishes for lively, open-ended explorations of current economic conditions and policy measures in the tradition of Hy Minsky.

We meet again in a political atmosphere that can only be characterized by endemic economic policy uncertainty, aggravated by perhaps even greater differences between the policies of the Administration and the preferences of the Congressional majority than were evident last year. However, this year, instead of unknown

unknowns, to coin a phrase, we have the experience of Congressional approval of a series of known, concrete measures on taxation and budget spending, the implementation and impact of which nonetheless remain largely unknown. We also have much clearer indications of likely measures in the area of trade and financial regulation. While some resemble policy measures implemented by past Republican administrations, some challenge traditional party orthodoxy.

It is hard to find a Republican administration that has not introduced measures to reduce taxes on the promise that they would pay for themselves, and I will suggest the historical antecedent for this belief in a moment. When this promise is disappointed by increasing fiscal deficits the response has usually been a call for a reduction in spending and legislation to balance the budget, eventually leading to modification or even a reversal of the taxation measures. Recall the experience of the Reagan Administration, and a subsequent episode of misreading of the lips.

The current Administration differs only in that it has not waited for the tax reduction measures to increase the deficit, it has moved to accelerate this result by a

direct increase in net spending embodied in the omnibus expenditure resolution. And true to form, a balanced budget amendment has already come before Congress, without issue, and there are rumors circulating that some of the provisions in the omnibus bill may end up under the bus. Speaker Ryan, who has been the most strident voice in arguing that deficits can be ignored because they can be eliminated by necessary incisions in entitlement spending, appears to have decided to leave the building, rather than take up that perennial fight. But he has agreed to stay on to fight for means testing, drug testing, and food baskets in pending agriculture legislation, which is where the issue of food security paradoxically resides.

It thus seems clear that we will have a repeat of the cycle in which Republican policy makers manage their cognitive dissonance and embrace balanced budget amendments while at the same time lamenting the profligacy of the poor in driving the increase in the deficit. Current conditions are thus likely to reinforce the Cheney rule: "Reagan proved deficits don't matter" and highlight the fact that the point at issue is not the fiscal deficits and the size of government debt, but rather entitlement

spending on “non-productive” activities. We may expect to see a revival of the Welfare Queens as well as adult entertainers on the horizon.

It is paradoxical that the part of the population most in need of government support provides the electoral base for those who propose policies to eliminate it. This suggests that while the theoretical case for managing fiscal policy to provide economic stabilization is secure, politically deficits are a non-issue.

Given the failure of Congress to manage its budget economically, monetary policy has become the sole tool of economic stabilization. While tight monetary restraint has been the traditional antidote to rising deficits, the persistent failure of unconventional monetary measures introduced after the Great Recession, and the associated contortions in the Phillips curve, has made such policy problematic. After serving as the asset price support policy of last resort in the recovery from the Great Recession, the Fed has become increasingly irrelevant as the length of the recovery achieves historical dimensions.

Indeed, in the current Administration monetary policy seems to have reversed its traditional role; the measure of success of the Federal Reserve is no longer controlling the rate of inflation, but rather in promoting increasing equity prices.

The new Chairman seems determined to continue to edge interest rates slowly upwards, channeling Alan Greenspan's belief that it is impossible to identify an asset bubble until after it has collapsed. What seems to have been forgotten in this context is Greenspan's surprise at the bond market's over half trillion dollar collapse in reaction to his reversal of interest rate policy in the beginning of 1994. This is perhaps the best guide to the market response to rising rates. And things may be even more dramatic if, as will be suggested tomorrow, the outstanding debt of private non-financial corporations is an order of magnitude higher than reported in official statistics.

The enthusiasm with which the Administration views equity prices as confirmation of the success of its policies, and the equanimity of the Fed on equity prices can only be explained by the belief that it is the prospect of a $1 trillion

government debt, rather than a bond or stock market break, which is the greatest threat to financial stability.

Somewhat paradoxically, it seems that it is the proposed remedies for the current account deficit that have greater impact on the behavior of the market than monetary policy. Indeed, the market response to the proposed introduction of tariff measures seems irrational, for it appears that the policy will result in the resuscitation of an old friend, the VER, rather than the imposition of tariffs.

For those who don't remember the experience of Voluntary Export Restraints when Japan was making America poor by stealing automobile jobs and outpacing our consumer electronics industry (anyone still have a Sony Walkman?), academic assessments concluded that VER's increase prices and profits for both exporters and importers, with the consumer bearing the burden. In the end it was not the VER's but the Yen "shokku" that drove Japanese producers to set up production facilities in the US and which provided the impetus for the geographical distribution of production facilities that created the supply chains that we now call "globalization".

Against this background of extreme policy uncertainty, and an increasingly tight monetary policy in the presence of what appears to be an overvalued stock market and historically low unemployment, it is surprising that analysts are not focused on when the current recovery will stumble and what policies remain to respond to even a mild recession. There seems to be some flexibility remaining in a rising participation rate, but as Herb Stein famously remarked, everything that must come to an end will.

While it is obvious that history never repeats itself, it has an uncanny ability to rely on past policies to try to deal with new problems. Consider the political context of the transition to peace faced in 1918. The IWW had initiated a series of strikes in 1917, followed by the Bolshevik revolution, and the creation of a US Communist Party and labour union -- what came to be known as the "Red" scare, suggesting a preamble to socialist revolutions such as were occurring in Hungary and Germany.

Recognising potential for political unrest that could be created by widespread unemployment as some 4 million soldiers returned to meet some of the 9 million workers being discharged from the war effort, Woodrow Wilson noted that "The

ordinary and normal processes of private initiative will not, however, provide immediate employment for all of the men of our returning armies. Those who are of trained capacity, … will find no difficulty, it is safe to say, in finding place and employment. But there will be others who will be at a loss where to gain a livelihood unless pains are taken to guide them and put them in the way of work. There will be a large floating residuum of labor which should not be left wholly to shift for itself. It seems to me important, therefore, that, the development of public works of every sort should be promptly resumed, in order that opportunities should be created for unskilled labor in particular, and that plans should be made for such developments of our unused lands and our natural resources as we have hitherto lacked stimulation to undertake." [1]

Wilson's suggestion was quickly taken up by Walter Weyl who proposed a policy of "Buffer employment … employment which absorbs the shock and jar of bad times,

[1] Selected Addresses Public Papers of Woodrow Wilson (1918), Albert Bushnell Hart, Editor. Chapter 93. Address Before Going Abroad (December 2, 1918).

employment which quietly takes on men at a time when otherwise they would be tramping in the streets look for jobs and releases them as soon as they are able to find other work at better wages. It is a method devised to lessen unemployment. The greater the impending unemployment the greater the necessity for a well-planned system of buffer jobs."[2]

William Hard, whom Weyl credited with the original idea of "Big Jobs for Bad Times"[3], followed by raising the question of how to provide popular support among the working class for a "reconstruction of business", rather than a more radical political solution: "If private enterprise can not supply the work, then the state must, … We did not stint our resources when the problem was one of destroying the alien enemies of democracy. Uncertainty as to tomorrow's bread, insanitary living quarters, the undernourishment of children, education rendered ineffective … are enemies of democracy as the Kaiser ever was."[4]

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[2] Walter Weyl, "Buffer Employment," The New Republic, XVII, 214, December 7, 1918, p. 159
[3] William Hard, "Big Jobs for Bad Times", Everybody's Magazine, Vol. XXXV, No. 2, August 1916, 129-41
[4] William Hard, "The Meaning of Reconstruction", The New Republic, 215, December 14, 1918

The question Hard was raising was whether popular support could be assured for a restoration of the prewar capitalism of big business and trusts without ensuring a guarantee that working men and women would participate in the benefits. His concerns were prescient, as in the two years following the Armistice some twenty-five major racial disorders erupted as returning soldiers found jobs filled by the emigration of blacks to the industrial North and the IWW had called the Seattle strike, while Britain was also beset by race riots and labour unrest. While today we recognize the benefit of employer of last resort schemes championed by Hyman Minsky on the merits of financial stability and macroeconomic stabilization, in the 1920s these programs were seen as providing institutional stability, a response to more radical solutions then in circulation.

But, in 1918 these proposals lacked resonance, for instead of the anticipated post-war recession, sustained government fiscal and monetary stimulus, along with strong export demand, provided employment growth, rapidly rising prices and the initiation of the Florida real estate bubble. However, as a result of the introduction of

tighter monetary policy, rising taxes and reduced government spending a fiscal surplus, declining exports and falling agricultural prices the boom "began to collapse in 1920 … and by 1921 ended in one of the most violent crashes of prices that the nation has ever experienced. The index of wholesale prices of all commodities fell from 227.9 in 1922, 150.6 in 1921 (1913 = 100). … Retail prices … fell between 12 and 13% in the two years. Industrial production … At the low point of 1921 in the second quarter of that year…. was 2% higher than in 1914. … … it is estimated that in 1921 there were 4,754,000 out of work. The crash brought about more than 100,000 bankruptcies. Before the reckoning was finally complete, 453,000 farmers had lost their farms."[5]

It is interesting to note the importance of this experience to the development of Hayek's malinvestment theory of the cycle, for he was a visitor to the US during this period; the correction was sharp and short and laid the way for the sustained

[5] George Soule, *Prosperity Decade*, From War to Depression 1917-1929m Volume VIII The Economic History of the United States, New York: Rhinehart & Co, 1947, p. 96

expansion for the rest of the decade. It provided the support for Mellon's subsequent advice to Hoover "...liquidate labor, liquidate stocks, liquidate the farmer, and liquidate real estate... "

In 1920 in the early stages of the recession a Republican administration was elected under the call by Warren Harding for a return to "Normalcy," which for candidate Harding meant "less government in business and more business in government." Normalcy was a catch phase to forget the political and economic problems of the war and return to pre-war conditions. For Harding this meant that rather than the threat of political instability due to unemployment "There is not a menace in the world today like that of growing public indebtedness and mounting public expenditures". An interesting idea when we recall that one of the first measures of the new administration was legislation against lynching.

In the face of the developing collapse, the economic policy of Normalcy involved both substantial reductions in tax rates, proposed by Treasury Secretary Mellon (after the liquidation of 1920-21) , as well as an increase in tariffs. These last two items are

of especial interest. The first because the recovery represents the justification for the Republican position that tax cuts pay for themselves. The top marginal rate, which had been increased after the war, was reduced in stages from 73% in 1921 to 25% in 1925 and the federal deficit fell from 6.5% to 3.5% of GDP. The unemployment rate, that Weyl and Hard were so worried about, had peaked at 12%, to fall to just over 3%.

While this rendition of events happily ignores the impact of technology on consumption and investment in the period, it also ignores two other factors. The first, is that despite the Cato Institute claims to the contrary[6] (conveniently forgetting the Federal Highway Act, the knock-on to consumption of the expanding ownership of automobiles, electrification, and radio, and the beginning of commercial aviation amongst other contributors to the age of mass production and consumption) the Mellon cuts did not lift all boats equally. The share of fiscal income of the top 10% of

[6] 1920s Income Tax Cuts Sparked Economic Growth and Raised Federal Revenues By Veronique de Rugy March 4, 2003 https://www.cato.org/publications/commentary/1920s-income-tax-cuts-sparked-economic-growth-raised-federal-revenues

the income distribution increased from 44 to roughly a 50 percent share, equivalent to that recorded in the US in 2015.

And despite the Roaring success of Normalcy, the Florida real estate bubble collapsed in 1925 and collapsing commodity prices led to desperation in the farm sector, with the result that although the Stock market was booming, the financial system recorded rising numbers of bank failures, topping at nearly 1000 in 1926, of mainly small, local banks that suffered from the depression in agricultural prices and the collapse of the post-war real estate boom.[7]

Finally the approval of the Fordney-McCumber Tariff act, which replaced the 1921 Emergency Tariff and produced an average tariff of nearly 50% on most dutiable (agricultural) goods[8] created an international disruption that made war reparations more difficult and contributed to the flows of capital from the US to Europe, which was used to meet reparations and laid the groundwork for the collapse of the

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[7] George Soule*, Prosperity Decade*, From War to Depression 1917-1929m Volume VIII The Economic History of the United States, New York: Rhinehart & Co, 1947, p. 152

[8] Source: *Three Dimensions of U. S. Trade Policy*, Chapter 2, p. 3. http://www.washingtontradereports.com/Analyses/Chapter2.pdf

European banking system in 1931. Given the need of indebted countries to run trade surpluses to meet debt service the tariffs were met with widespread, targeted retaliation, in particular on automobiles. This is of course the context of Keynes' Economic Consequences of the Peace and the discussion with Ohlin of the transfer problem.

Thus the policies so far introduced by the current Administration appear to follow the Harding-Mellon playbook on taxation and trade policy. Curiously, there are a number of other similarities. Although Trump cannot be accused of a return to "Normalcy", in terms of new technologies the period was certainly destructive if not disruptive. The current policy of "energy dominance" brings to mind the Teapot Dome scandal and the first conviction of a sitting Cabinet minister. Harding also had difficulties with cabinet choices and a penchant for appointing relatives to government positions. Major scandals erupted in the Department of the Interior, the Veterans Bureau, the activities of his Attorney General, and even touched the head of the Federal Reserve who was subsequently indicted for fraud. And then there was the

problem of the mistresses, and an inability to control the public airing of his extra-marital affairs.

As to the social impact, George Soule notes of this period[9]"The Ku Klux Klan for a time built a tremendous organization on the aimless unrest, foreshadowing the Nazi movement in Germany by mobilizing hostility against Jews, Negroes, and Catholics. … Technology produced countless new gadgets in increasing numbers while it added to the insecurity of employment." It would appear that there is little difference in the basic economic and social policies employed by a return to Normalcy and introduction of Economic nationalism.

Last year's Introduction to this Conference drew a parallel between the New Deal policies to respond to the needs of the "forgotten man" who had lost self confidence and had given up on the ability of government to remedy distress, noting that Trump had channeled this approach, appealing to those (eventually described by the Democratic candidate as "deplorables", Marx would have said lumpen proletariat,

[9] P. 3

Kant rabble, or sans culottes of the French Revolution) who believe they have been passed over by changes in technology and global supply chains, with their jobs taken by immigrants or foreigners and playing on their belief that government had abandoned them in favour of globalist elites more interested in regulations to defend disappearing frog species and water courses that closed mines, or to impose the right to eat cake and use bathrooms at will. Thus instead of restoring confidence in the ability of government to provide remedy and support, the resentment is channeled to the coastal elites in the government, immigration and foreign competition more or less in that order. Instead of savior government becomes the swamp-infested enemy.

Whereas Roosevelt provided policies that restored confidence in the ability of government to support the "forgotten man" by charging it to play a more direct role in the economy, and relied on experimentation to find what worked, the current administration has responded to the plight of the excluded as an excuse to follow traditional Republican policies of tax cuts and expenditure policies that will have little impact in improving conditions in mining or manufacturing or other sectors where

employment is currently under threat. Nor will the trade measures provide direct support. While rants against immigrants and the elites provide succour to the resentment felt at the abandon by government, they do little to improve the conditions that have produced support for restoring coal, draining the swap and building the wall.

Comparison with the Wilson and Roosevelt policies suggest that it is only by providing more direct governmental measures of support to the marginalized population can we provide political stability. Following the traditional Republican mantra of reducing the size of government and the scale of social entitlements seems in direct contradiction to the promises that have been made. Future policy will depend on the pressure to reverse strategy and restore these policies as well as determining the political evolution that it will generate.

Whether the Republicans or Democrats will respond with direct measures cannot be foreseen. What can be foreseen is the possibility that the evolution of AI and robotics will expand the ranks of the “deplorables”. The response that is currently on

offer is universal basic income. One proponent, when asked if this would not run counter to the need to contain government deficits, responded that the deficits would be negligible since prices would fall substantially. Given that the current administration cannot engineer policy that expands entitlements for the deplorables, it seems unlikely that any future administration would be willing or able to do so.

But this is not the major problem – which will be the ownership of low–maintenance, non-labour means of production and the financial conditions for their creation. As Minsky insisted, capitalism is a system in which the control over the means of production takes place by borrowing. Which raises the question of how these debts will be validated, and if there is no debt, how profits will be supported. Basic questions that fall in the rubric of Minsky's concern for financial fragility. Or perhaps money manager capitalism will be replaced by robot capitalism.

Our conference panels and speakers will address a number of these issues, starting with the short-term outlook and then evaluating the possibility of a modern "buffer employment" scheme along the lines proposed by Hyman Minsky. We will also

investigate monetary and trade policies as well as the underworld of debt accumulation on a national and global scale as an indication of the underlying financial fragility that may be unleashed by policy volatility.

As you are all aware, there is a Minsky cycle that pervades the profession – which is forget about him in the good times and trot him out when the crash comes, pretending that you saw it coming all along. One of the major objectives of the Institute is to keep thinking about Minsky in the good times, because that is when he is relevant and measures can be taken to remedy fragility – after the crisis breaks, not so much. It is interesting that the retiring head of the PBOC Zhao Xiaochuan has recently tried to alert policy makers in China to the importance of Minsky thought before the crisis.

As in past years we invite you to take a look at our web site (or take with you some of our publications available at the back of the room) and would very much welcome your comments.

In addition I would like to draw your attention to the Institute's Graduate Programs in Economic Theory and Policy. Next year our two-year Master of Science will be complemented with a one year Master of Arts. We encourage you to bring it to the attention of any students interested in the alternative approach to theory and policy offered at the Institute

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

Thank you very much for your attention.