from Red A disc

Why Not Give Full Employment a Chance?

Hyman Minsky and Dimitri Papadimitriou
Jerome Levy Economics Institute
Bard College: Annandale on Hudson
New York, 12504

First prepared for the
Southern Economic Association meetings, Washington D.C.
Brought up to date Dec 31, 1992

Preliminary version. Jan 7 notes

!. Introduction

> IF TO DO WERE AS EASY AS TO KNOW WHAT WERE GOOD TO DO, CHAPELS HAD BEEN CHURCHES, AND POOR MEN'S COTTAGES PRINCES' PALACES"
> Portia, The Merchant of Venice, Act 1, Scene 2 :

The exercise in Little Rock served several useful purposes. It showed that Bill Clinton appreciates ideas and has a low tolerance for cant. It - along with the cabinet appointments - demonstrates that the social vision of the new administration is clearer than its economic vision. In addition it reminds us that Shakespere's philosophy of policy is only approximately valid when applied to economics.

Portia's statement is wise but not precise. It is wise for it clearly separates economic policy into two stages, the setting of objectives and the development of instruments designed to achieve these objectives. It is imprecise because it seemingly assumes that the objective economic policy aims to achieve is easy to know.

In setting economic policy it is not easy "to know what were good to do", for "what were good to do" has many faces. Identifying and ranking "what were good to do" in economic policy is a difficult matter, for desirable objectives are often mutually exclusive, or alternatively, "what to do" to gain more of one may lead to the sacrificing some of another "what were good to do".

In Little Rock much was made of a trade off between stimulus now and reducing the deficit, i.e. lowering the burden of the government's debt. But this trade off is really of secondary importance. Everyone knows that the Government's debts have to be serviced, and when servicing costs become so great that they close off desirable programs they impose a burden on the economy. This burden lightens when servicing charges increase at a lower rate than the economy expands. This can be achieved by the government debt increasing at a slower rate than the economy: it can also be achieved when interest rates on Government debt falls. Lightening the burden of the debt frees tax resources so that measures "to do" can go forward.

In Little Rock not much was made of what Clinton administration should take as its primary economic objectives. A distinction needs to be made between the primary and the instrumental objectives of economic policy. The primary macroeconomic policy goals are states of the economy, such as exchange rate stability, price level stability, full employment and economic growth. To achieve these goals instruments of macroeconomic policy are maneuvered. Macroeconomic maneuvers include monetary and fiscal policy actions as well as legislation which affects the institutional structure of the economy.

At Little Rock the trade off between short term stimulus or deficit reduction was discussed, but this discussion was not in terms of how maneuvers undertaken in an effort to achieve these intermediate goals would affect the primary policy objective of the administration. From what outsiders could gather, one reason for this ommision was that the question of what the primary economic policy objectives of the Clinton administration should be was not addressed: it was not on the agenda.

If the Clinton administration is to be an effective engine for change, it will have to make its primary econommic policy objectives precise. Over the past century the primary policy goals of the United States have undergone a number of dramatic changes. Among the primary policy objectives exchange rate stability, price level stability, full employment and economic growth can be identified. The thesis of what follows is that given the structural characteristics of the United States economy and the competence of economic policy, the primary policy objectives in the next four to eight years should be the achievement and the sustaining of a closer approximation to full employment than has been achieved over the past decade together with reasonable price level stability.

2. Alternative Primary Goals for the American Economy.

Earlier in our history macroeconomic policy revolved around stabilizing the exchange rate of the dollar vis a vis other currencies. In the late 19th century this led to the adoption of the gold standard. The opposition to the gold standard was vividly encapsulated by William Jennings Bryan in his Cross of Gold speech at the Democratic Party's 1896 Convention. Experience led to the characterization of the gold atandard as a "straight jacket", preventinmg effective action to foster the capital developemnt of the economy and to maintain employment. This led to the abandonment of the gold standard as a primary policy objective.

The gold standard is a fixed exchange rate system. Because a fixed exchange rate system has the advantage of minimizing the risks of lenders on international account, it continues to have support. Recent experience shows that in the financially complex modern world a fixed exchange rate system is vulnerable to disruptions which bring about large changes in standards of living and asset values.

The Federal Reserve System of 1913 was a response to the financial crisis of 1907 and the depression that followed. It was an attempt to mimic the gold standard in determining the money supply, even as it provided for an elastic currency both to meet the needs of trade and to contain financial crises. After the great monetary and financial collapse of 1929-33 revealed the shortcomings of the original Federal Reserve act, by 1936 the New Deal put a financial system in place that had a more flexible Federal Reserve System, a compartmentalized financial structure, deposit insurance and the doctrine of transparency to guide behavior in financial markets and the governance of publically held corporations.

One aim of the New Deal was to assure that "never again" would the United States suffer from a financial collapse that led into a deep depression. The United States has avoided a deep depression for well nigh sixty years, a remarkable record in the light of our earlier history. In the current period the deep depression that was implicit in the exposed financial structures that were the product of the 1980's was prevented by the Treasury's underwriting of the par value of deposits, at savings and loan associations and commercial banks (what the press and some economists call a bailout of these institutions), and massive Federal government deficits, which sustained business profits and therefor employment.

In the absence of the financial system reforms of the 1930's and the vastly larger government we now have, both of which are the legacies of the New Deal, we would have experienced a much worse decline in income and employment in the 1990's to date than we have as yet achieved.[1] The contained depression thesis, as advanced by S. Jay and David Levy, implies that for the American Economy to achieve a return to full employment requires than some fiddling with dials marked fiscal stimulus or monetary ease is needed.

1. S. Jay and David Levy of the Jerome Levy Economics Institute have been most acute in advancing the contained depression interpretation of the recession of early 1990's.

The contained depression thesis also implies that "false" recoveries will occur: transitory bursts of favorable data will indicate that a recovery has begun, only to have later data show that another recession has begun.

A major aim of the New Deal and the economic policies of the immediate post war world was to achieve and sustain full employment. This aim was embodied in the Employment Act of 1946. On the whole the immediate post war period did achieve a closer approximation to a sustained full employment combined with reasonable price stability than had been true up to then.

In the 1960's a subtle shift occurred in the aim of economic policy: policy changed from attempting to achieve full employment to fostering economic growth. Policy makers suggested that business cycles were a thing of the past and that hitherto instead of recessions we would at worse experience growth recessions. In place of full employment as a goal the concept of the non-inflationary employment level was introduced as a limit to what a limited arsenal of policy instruments could achieve. This concept became a rationalization for accepting ever increasing rates of unemploment as the best our economy can be expected to deliver.

As the Johnson-Nixon period developed the rate at which the price level increased rose. The absence of an agreed approach to wage setting durng the Viet Nam era led to an acceleration of price increases. The recurring political squabble over legislation to adjust government pay scales and transfer payments to inflation led to the indexing of government salaries and transfer payments. The two oil shocks of the 1970's which occurred when OPEC exercised its monopoly power added to the rate of inflation.

Beginning in the late 1970's economic policy has been dominated by attempts to combat inflation by constraining the rate of increase of so called monetary aggregates. The initial result of this policy mix was a pattern of interest rates which drew funds from abroad into dollars, even as the high interest rates compromimsed the equity base of many savings institutions. The pattern of exchange rates which resulted in the early 1980's brought about a hugh deficit in trade and a virtual destruction of industries such as automobiles and consumer electronics. In the conservative political and intellectual environment of the time the cry went out that wages were too high, when in fact it was the exchange rate, driven by the monetary constraint that followed from the assertion that inflation is always a monetary phenomena, that was too high.

The inflation of the 1970's led to price level stability becoming the dominant objective of economic policy. During the 1980's inflation was fought by constraining the growth of monetary aggregates and by destroying the power of trade unions through imports and unemployment. Inasmuch as the 1980's was a period of intense innovation in financial markets, the amount of available financing was cut loose from its traditional relation with the financing available from banks and savings institutions.

Four different primary goals have dominated economic policy in the century or more that the United States has been an industrialized economy: exchange rate stability, price level stability, full employment and economic growth. Each of these leads to a different institutional structure and to a different use of the available policy instruments. In 1992 exchange rate stability is a minor concern. At the Exercise in Little Rock much was made of avoiding inflation and economic growth. Little was said about full employment as a primary goal for the American economy.

The agenda in Little Rock did not examine the policy and operational significance of emphasing full employment as the main policy objective. It is the thesis of what follows that the United States should emphasize full employment as the primary policy objective and allow the chips to fall where they may with respect to economic growth.

3. Growth Versus Full Employment as the Primary Policy Goal.

Economists can speak with some authority about the measure and the concept of full employment. We know not what to do to achieve economic growth and we cannot measure it in the policy relevant run of time. Furthermore experience shows that a full employment market economy grows, a market economy can grow even as it fails to achieve full employment. After the event we can argue that the United States economy grew between 1933 and 1940 although private sector employment was low throughout this period. It was the growth in the absense of expansion during the 1930's that enabled the United States to have both butter and guns during the second world war.

Did our economy grow in the third quarter of 1992? The official answer is that Gross Domestic Product grew at a 3.4% annual rate during that quarter. But in truth we do not know if the economy grew or shrank. The index number that is called domestic product rose a bit less than 1.0% in the third quarter. This rise enables us to say that Gross Domestic Product expanded at an annual rate of 3.4%: it does not enable us to say that the economy grew rather than shrank in that period.

The distinction between calling the measured 3.4% rate of expansion a growth rate rather than an expansion rate is more than a question of truth in labeling. Economic growth is a measure of what happens to productive capacity, and we don't know what happened to productive capacity during the third quarter of 1992. The productive capacity of an economy is determined by the quality and quantity of its labor, capital assets and organizational arrangements. As a result of the end of the cold war and the recognition of the obsolescence of factories, firms and product lines the argument can be made that the capacity of the United States economy to produce has decreased over the past year.

Innovation is often characterized as the engine that powers economic growth. Economic growth based upon innovation is a process of creative destruction. In the United States the downsizing of General Motors, IBM, the defense industries, the deteriorating infrastructure, the aging of airline fleets, as well as the redundantcy of many labor skills implies that destruction is taking place. The weak investment demand is evidence that the creative part is not vigerous. Nevertheless the large government deficits and the Treasury's refinancing of financial institutions have contained the fall in income and employment. The apt label for the situation of the American economy (as well as the economies of Europe and Japan) is stagnation.

The stagnation hypothesis of the 1930's was an explanation of the incomplete recovery from the Great Contraction of 1929-33.[2]

There were three phases to the Great Depression of the 1930's: a great contraction of 1929-33, a recovery of 1933-

2. The stagnation hypothesis is associated with Alvin Hansen, whose special interpretation of Keynes was important in formalizing the American Keynesianism of the 1950's and 60's. One form of the stagnation hypothesis took the form of assertint that investment oppertumities were exhausted.

35 and a long stagnation from 1935 until the government financied spending associated with rearmament and war took over after 1939. The then current explanation of what happened was couched in terms of the exhaustion of investment oppertunities. We now have trouble with that explanation, for the 1930's seems to ahve been a rather buoyant period in product developement.

We would now explain the stagnation of the late 1930's as the long aftermath of the virtual destruction of the financial system between 1929 and 1933: a destruction that led to the closing of all banks in February and early March 1933. Because of the combination of government deficits, which sustained income, and deposit insurance, which prevented the pass through to losses on assets to depositors in the protected institutions, only a partial destruction of our financial system has taken place over the past four years. As far as the hits that the financial system took over the previous four years the mess that Clinton inherits from Bush is not in the same league as the mess that Roosevelt inherited from Hoover. Nevertheless the disruption of our financial system since the stock market break of 1987 is the greatest financial trauma in the sixty years since 1933. Because the New Deal institutions such as deposit insurance and Social Security etc. worked to contain and abort the downward cumulative interaction between falling gross profits and collapsing asset values a full blown financial disaster was averted.[3] nevertheless we can expect the hits that the financial institutions took during the past five years to lead to a reluctance to finance during the first years of the Clinton administration.

The Significance of Finance

Economic policy has to be made for the economy that exists, not for the economy as simplified in the abstract models of Economic Theory. The American economy is a capitalist economy with a complex financial system in which contracts that exchange money "now' for money "later" are integral to the operations of almost all markets. In this economy nothing happens without being financed and for a wide variety of activities this financing takes place through the intervention of the institutions whose operations are only financial: they issue financial liabilities in order to acquire financial assets which they use to acquire assets that are financial liabilities of other units. This economy with its complex, ever evolving and pervasive financial (or monetary) relations does not conform to the economic model of the standard text books in which financing is dismissed with a handwave. In particular in our world, which is permeated with contracts that link the past, the present and the future, rational agents are

3. Hyman P. Minsky, Stabilizing an Unstable Economy, yale University Press, 1986

S. Jay and David Levy Title of Levy institute White paper and forthcoming book.

aware of their own fallibility and their ignorance of the true characteristics of the economy. A world with such agents and modern finance is not an inherently efficient seeker of equilibrium.

In examining the effects and feasibility of policies the questions which must be addressed include "what organization is expected to be the proximate source of financing?", "What financial instruments will be used?", "How will the money now part of the financial contract be used?", and "Where do today's transactors expect the funds for the money later part of the contract to come from?. Furthermore the willingness and the ability of financing organizations to enter upon new financing contracts depends upon whether or not financing contracts entered into in the past are being fulfilled.

Considerations regarding financing are of critical importance in selecting a policy mix for the years following 1993. The financial system took many hard hits in the past five years. Financial institutions failed in large numbers and many others came close to failing. Any policy initiative which requires a large flow of financing of private activities by banks and other institutional sources of financing is likely to yield unsatisfactory results in this time frame.

Investment tax credits increase the internal funds available for the financing of investment by lowering the tax rate on profits. They are not likely to yield a large burst of financed investment in the current environment. Investment is financed by a combination of internal and external funds. Investment tax credits are expansionary to the extent that the financing of the investment that takes place requires exrternal funds: requires borrowing from banks or the sale of securities on financial markets. The experience by banks with lending over the recent past combined with the unsatisfactory state of bank balance sheets implies that the reluctance to lend to businesses by banks is greater than in the past. Prior experience with investment tax credits is not a reliable predictor of what can be expected from investment tax credits now because the prior experience took place when the financial system was much more robust than it is now. In the 1960's when the Kennedy administration used investment tax credits, the 1930's were a memory whose impact on current decisions was rapidly decaying. In 1993 the full impact of financial trauma on portfolio structures is still to be realized. Furthermore the current weakness of the Japanese banking sytem means that the external fiannce that the Japanese banks provided to American enterprizes in the past decade will not be forthcoming.

The Federal Reserve System

In 1991 and 1992 the economy did not respond to the Federal Reserve's policy promoting monetary ease. This shows that the Federal Reserve can be ineffective in stimulating an expansion. However whilst the Federal Reserve cannot guarantee an expansion, by constraining the ability of the banks and the financial system to finance private spending it can stifle an expansion.

The Federal Reserve is not ruled by a cadre of impartial technicians. Over the past twelve years the appointments to the Board of Governors of the Federal Reserve and to the Presidencies of the twelve Federal Reserve Banks have been mainly believers in monetarism and supply side economics. The Clinton administration cannot count on the Federal Reserve's monetary policy to be supportive of an expansionary fiscal policy, for the monetarist belief, shared by the present Republican appointed membership of the Open Market committee is that monetary policies that accomodate an expansionary fiscal policy are inflationary, if not now or in the near term then eventually.

The character of the men determining policy for the Federal Reserve Board puts President Clinton in a bind. If a bold fiscal policy is undertaken he needs to enlist the support of the open market committee and the Board of Governors so as not to unduly alarm the financial markets. But these bodies are made up of honorable men who truly hold their beliefs. Their beliefs will determine their actions and a clash between the administration and the Bank will occur.

Any fiscal policy to jump start the economy is doomed to fail unless it triggers a rise in financed private spending.[4] The monetarist view that undo expansion of the money supply leads to inflation is likely to be a powerful determinant of the decisions of the open market committee. While the words of the Federal Reserve may proffer cooperation, the deeds are likely to belie the words.

In order to get a cooperative Federal Reserve the Clinton presidency may have to pick up the Bush administration's idea that the Secretary of the Treasury and the Comptroller of the Currency become members of the open market committee and the Congressional idea that either the Presidents of the Federal Reserve Banks should not be on the open market committee or that they should be nominated by the President and confirmed by the Senate..

The independence of the Federal Reserve System is a doctrine that carries much weight in our political rhetoric and in the set of beliefs that guide the actions of agents

4. If the battery is dead jump starting the car will get the car moving but the battery remains dead. Once the car stops it needs another jump start. Jump starting as a metaphor for economic policy only makes sense if the economy is analogous to a live battery that has somehow been run down. But if the battery has somehow been shorted then jump starting is ineffective. The financial system trauma is equivalent to an assertion that the battery is dead and something more than jump starting is needed.

on financial markets. The present members of the Board, as monetarist ideologues may well dominate Federal Reserve policy making, posing a serious quandary for an expansion oriented administration. It has been suggested that the disastrous monetary policy of the last year of Carter's term was a preemptive strike by the Federal Reserve System against the embryonic plan for an incomes policy. <u>The disastrous consequences of the application of practical monetarism in the early 1980's supports the view that monetarists are dangerous in positions of power</u>.

3.The United States is a Very Rich Country.

In spite of the mismanagement over the past twelve years the United States remains <u>a</u> very rich economy. The full employment gross domestic product of the American economy is well in excess of $6,000 billion. In developing new and revamping old programs the huge size of the economy means that even a very big number, such as $50 billion, is well less than 1% of the gross domestic product.

The present unemployment rate is some 7.4%. If we first assume that the measured unemployment that approximates full employment is 4% and further assume that GDP increases 3% in for every 1% decline in the measured unemployment, then the gap between actual and full employment GDP is more than 10% of present GDP. This gap implies that a policy that succeeds in spurring expansion can experience several years in which increases in nominal GDP are 6% to 9% per year, where some 2% of the nominal increse is due to inflation. In our economy gross domestic product can increase by between $360 Billions to $540 billions per year.

The gross government debt is now approximately $4,000 billions. The burden of the debt depends upon the ratio of debt to gross domestic product and the interest rate on the mix of government securities outstanding. At the end of World War II the government debt was almost 130% of gross domestic product. From 1945 to 1981 the cumulative growth rate of gross domestic product was much greater than that of debt: as a result thes ratio of government debt to GDP fell to about 33%. Over the last twelve years the ratio of the debt to GDP doubled. The gross government debt is now in excess of 67% of the GDP. The public concern about the accumulated debt means that a prudent fiscal policy requires that the gross government debt grow at a lower rate than that of the GDP. The administration should use its bully pulpit to emphasize the significance of the debt to GDP ratio. The public opinion dictated policy objective is to lower this ratio: this constrains the use of a strong fiscal stimulus.

Because of the size of the economy new and revamped social programs that would replace welfare with work, which seem to cost a great deal, really cost very little when measured as a ratio to the gross domestic product. Along this line of thought, a judicious use of considerably less than $50 billion in spending can do a great deal to set the stage for serious economic betterment.

The Perot candidacy and the 19% of the vote he gathered has changed the discourse. It placed the addition of broad based taxes to the revenue system of the United States on the political agenda. A phased implementation of a gasoline tax and a tariff for revenue makes a short term fiscal expansion consistent with an enacted tax program which, when fully effective will lower the ratio of the government's debt to GDP.

4. Inherited barriers to prosperity

Clinton inherits two barriers to prosperity from Bush. These are:

1. a severely weakened financial system, and
2 a fiscal mess.

THe main economic task of the Clinton administration is to undo the harm done to the financial and fiscal fabric of the American Economy over the past twelve years.

The Weakened Financial System

One of the first acts of the Clinton Administration should be to join Congress in setting up a NATIONAL MONETARY

AND FINANCING COMMISSION that is charged with restructuring private and government financial institutions. The charge to the commission should be to develop a system of private financial institutions that reflects the complexities of an advanced financial economy and which will be able sufficient to sustain prosperity in the United States and a set of government agencies and financial institutions that will regulate, supervise and backstop the private institutions.

We may very well be in as deep a need for such restructuring as we were in the aftermath of the crisis of 1907 and the Great Collapse of 1929-33. This restructuring should not look mainly to the safety and convenience of the payments mechanism, these concerns being rather trivial, or even to minimizing the cost to the Treasury of any future need to refinance the financial system in the aftermath of a serious malfunctioning of financial institution. The main charge of the Commission should look to the development of a financial structure that supports and facilitates the capital development of the economy.

The financial structure Clinton inherits has been grievously wounded. The "hits" the institutions of our private financial system took during the past four years have greatly decreased the ability and willingness of our presently surviving financial system to finance a self sustained economic expansion that is based mainly upon the private financing of productive inestment.[5] The hits were in good part a consequence of the casino economy of the 1980's. The strengthening of our financial system requires that existing private financial institutions be augmented by new private financial institutions, new government institutions that provide regulation and support and new government institutions that cooperate with private financing sources in the financing of investment.

The debacle in the Savings and Loan industry was due first to the impact of interest rate volatility upon the net worth of Savings and Loans, second to the insane deregulation that took place even as the Jimmy Stewart's of the industry[6] were being replaced by con artists, and third to the proliferation of assets which became non-performing that the con men and their investment banker associates placed into the portfolios of Saving and Loan associations.

---

5. Over the past years Japanese Banks played a major role in the financing of American business. The news from Tokyo as this is being written is that the same problem of non-performing assets that continues to plague the American banks is affecting Japanese banks. Inasmuch as the Japanese banks took major hits from the problems of the American economy the past several years, we should not expect to see a quick infusion of financing from Japan into the United States' private sector. Over the near future we can expect the Japanese surplus from exports to the United States to be placed into safe government debts rather than into private equities and debts. The Japanese banking problems will help maintain and even increase the gap between government and private financing conditions in the United Sates.

6. In the Frank Capra film "Its a Wonderful LIfe" the character played by Jimmy Stewart apparently was a officer of a Building and Loan Society, a precursor of the Savings and Loan, although in the replaying of the reel of life the Stewart character apparently financed businesses. We should also note that the villein, Lionel Barrymore was apparently a banker.

The Savings and Loan Association debacle was followed by "crises" which are still unfolding in Commercial Banking, Insurance Companies, Finance Companies and Pension Funds, to name the most prominent classes of intermediaries that have taken serious "hits" to the performance of their assets over the past five years. Furthermore many operating corporations became so over indebted in the 1980's that they became very vulnerable to bankruptcy if the rate of increse of their revenues declined. The crisis in the American airline industry is the result of a combination of inept deregulation, speculative over indebtedness and the impact of the stagnant economy.

As a result of the cumulative impact of these developments the financial structure that is in place is not capable of financing an American prosperity that is based upon private demand.[7] The Clinton administration cannot count on private business to lead the economy out of its current malaise even after a fiscal stimulus that, to use the common phrase, jump starts the economy.

7. The financial system is more grievously wounded than at any time since the great collapse of 1929-1933. After the final debacle in early 1933, the private financial system was not able to finance sufficient private demand to generate full employment until 1948 or so, when we once again had a private financial system that was able to finance sufficient demand to sustain a close approximation to full employment. Even so the 1948 sufficiency was based upon a set of government guaranties and financing institutions that had not been present earlier. It seems as if the United States economy needs the prop of government deficits or government assisted private financing if a close approximation to full employment is to be achieved.

The recent losses on many categories of assets and the weakened equity base of many units make it natural and normal for the standards that private financial institutions apply in 1992 in evaluating propositions to finance to be stricter than the standards of some eight years ago. Bankers and apologists for bankers may blame the tightening of regulation or the Basle agreement on capital absorption ratios for different classes of assets, but the main cause for the tightening of credit standards is the experience of institutions in the financial system with non-performing assets.[8] It will take several years, and most likely institutional changes, before the balance sheets of financial institutions will be sufficiently robust and the agents who operate the financial institutions will be sufficiently secure about the health of their own institution and the prospects of those they would finance so that the financed private demands of businesses and households will be sufficient to enable the economy to realize a close approximation to full employment.

---

8. The concept of equity absorption as the control over the quality and quantity of bank financing may be counter productive in an economy where contagions of non performing assets occur. Non-performing assets are a result of the cash flows falling below some perhaps optimistic expectation but as bank equity is the difference between the value placed upon assets and the value of liabilities, an increase in non performing assets implies a decrease in capital. If bank lending is a determinant of the aggregate investment, if bank lending is constrained by bank capital then an increase of non performing assets will lead to a decrease in bank asset acquisition, which decreases bank financed investment, which decreases corporate profits, which in turn leads to a new round of non performing assets.

Furthermore the points of contact between the government's regulatory and control mechanism and the organizations that now finance businesses have been much attenuated by the evolution of the financial structure. An easing by the Federal Reserve of money market financing terms does not now quickly translate into an increase in financed spending. Banks and the monetary liabilities of banks are now much less important in financing prosperity than they were earlier in our economic history. Our economic policy apparatus has not adjusted to the consequences of the electronic revolution in communications and computation.

One effect of the crises in the Savings and Loans, commercial banks, and investment banks is a decrease in the number of independent financing sources for business. The closure and the merger of banks and savings and loan associations also means that the average size of the surviving institution has increased. The normal financing habitat of a bank is determined by its capital. If we use the two rules that a bank has some 8% capital to liabilities and that 10% of its capital is the largest financing relationship that prudence permits, then a $1 billion bank will have $80 million in capital and the largest financing it can comfortably do for its own account is $8 million. The loan portfolio of such a bank will consist of loans to moderate size businesses. By the same calculation a bank of

$100 billions in assets will feel comfortable extending financing lines of $800 millions.

The evolution of banking and finance over the past 12 years has diminished the number of sources of business financing that specialize in credit lines of $1 million or so. There is a need to create a new set of banks whose main asset will be the result of financing smaller businesses.

Commercial banks are trying to eliminate servicing the smaller depositor. The reason is simple: banks lose money servicing smaller accounts. There is a need to create a new set of banks which services businesses and households which do not carry large accounts: which service our inner cities and our micro-businesses.

Without looking to preempt the work of the suggested monetary commission, one element of a modernized financial structure may well be the chartering by the National Government of <u>Federal Community Development and Service Banks</u>. These Development Banks will have up to three departments. One is a payments service department which will have both deposits subject to check as well as non-checking accounts. The asset structure of this department will be limited to government securities and highest quality short term private debts. These liabilities will be fully guaranteed by the Federal Government without limit and after an interval they will be the only deposits which have this guarantee. The provision of payments services shall be a profit center for these banks. The payments service should not be offered as a "gift" to individuals and institutions that use the services of the other departments.

Because of the quality of the assets this department holds it will be allowed to function at a 30 to 1 or even a 40 to 1 asset equity ratio.

The second department will be a mortgage initiating and packaging organization which will finance its activities with its own capital, the sale of mortgages in packages, and a series of funds which resemble mutual funds. In every mortgage based mutual fund a bank sponsors some 7% is to come from the bank's own equity.

The third department will be an investment bank, which will administer a variety of funds which resemble existing mutual funds. These assets in these funds are to be limited to businesses in the bank's service area. These funds will vary from equity funds to long and intermediate credit funds. There will be no fixed value to the liabilities, but the sponsoring bank will be required to invest about 10% of its own funds in every fund it sponsors: the bank investment is to serve as a quasi equity, in that it absorbs the first 5% or so of portfolio losses. In addition to the development banks investment of its own capital to create a risk absorbing financing tranch, the there might well be a government owned Federal Bank for Development Banks which will match the equity investment in such banks with a long term debt or an equity investment.

The development bank funds will differ from existing mutual funds, in that the capital of the managing bank and of the government will take the first 10% or so of the losses due to non-performance of assets and the investments of share owners of the funds will be term investments. Investment in these funds is not as liquid as investing in existing mutual funds.[9]

The Development Banks will be small business development agencies for area it serves.

As mentioned earliesr there should also be a Government Bank for Development Banks which will act as a co-investor in the funds sponsored by the development banks as well as a source of liquidity for these Banks.

The current status of the financial structure means that publicly financed demand will have to make up for a deficiency in privately financed private demand if a close approximation to full employment to be achieved during the first years of the Clinton administration.

Publicly financed demand takes two forms. One is public, private and state spending that is financed either

---

9. One charge to the Monetary and Financing Commission will be to examine how the mutual fund and pension funds affect the financing of the capital development of the economy.

by the Treasury or by markets which accept debts endorsed or guaranteed by agencies of the Federal Government. The second is by a government financing institution which directly finances specified classes of investment. Both of these devises were used during the long haul from 1929-33, when the private financial structure was destroyed, until 1948, when the private financing of investment demand became dominent. Both the recovery from the Great depression and the great war were largely financed either directly by the government or by government financing organizations.

Some hard thinking is needed by the National Monetary and Financing Commission about what should now be put in place that does the job that organizations like the Reconstruction Finance Corporation and the Rural Electrification Authority did during the Depression.

One aspect of the institutional flaw in our financial markets is illustrated by the inability of a major company, McDonnel Douglas, to finance the construction of a new generation of large passenger planes. Undoubtedly the McDonnel plane is a spin off of the technologies that underlies the new military transport plane that McDonnell is building. The spectacle of McDonnell Douglas shopping this technology in Japan, Taiwan and China because domestic financing was not available is evidence that something is amiss in our financing structure.[10]

10. The Boeing 747 was one of the most successful export monopolies ever held by a national state. The McDonnel

A financing arm of the government which can invest both equity and long term debt money into such a project is needed. Europe and Japan do not hesitate to invest government or quasi government monies in long range investments which involve such large development costs that private investors shy away from because they would involve "betting the company".

This hole in our financing fabric indicates that there is a need for a Government Holding Company, similar to the RFC of the 1932-1950's period. A $10 billion equity investment by the government together with a $40 billion authorization to borrow in financial markets Federal Development Bank should be chartered. The aim will be to foster the emergence of products which have been developed to the market.[11]

The Fiscal Problem

The huge vote for Perot can be interpreted as a mandate for bringing the budget closer to balance by a serious revision of the revenue system of the United States. One of the first acts of the Clinton Administration should be to

---

Douglas plane may well be an opportunity for another such monopoly.

11. It should be noted that if the government ran its accounts like all others do an investment of say $10 in a Development Bank would lead to an asset being added to the Government's account even as it borrows $10 billions to finance the investment. There is not increase in the government debt by such a transaction.

ask Congress to set up a Commission on the Revenue of the United States.

For government, as for businesses and individuals, the burden of a debt is measured relative to the income that finances the carrying charges and the repayment schedule of the debt. One dimension of the fiscal mess is the sharp increase over the past 12 years in the government's debt relative to gross domestic product, even as the public infrastructure, which aids and abets the productivity of private enterprise, deteriorated. Since 1980 the spending side of the government has not been supportive of private productivity and the well being of the working population. A shift of government spending towards productive activities and activities which increase the well being of the public is called for. Such a shift would enhance both the immediate and the longer term well being of the community.[12]

There is an obvious need to reduce the deadweight burden of the public debt. This cannot be done in one fell swoop. It must be the target of a budgetary realignment by which over a run of years dollar gross domestic product grows at a faster rate than the debt. Policy needs to target a reduction of the ratio of federal government debt to our gross domestic product, not a total elimination of the debt. Tax and spending policy must be calibrated so

12. There is a need to modernize the welfare state in the light of demographic changes. One prerequisite for such a modification is a resetting of the age at which people go from the labor force to being retired.

that over the next decade the percentage increase in the Government's debt is significantly smaller than the trend percentage increase in the gross domestic product.

An increase in the gross government debt of 1% to 2% of Gross Domestic Product is tolerable if we can achieve an average 4 or 5 % increase per year in the dollar value of Gross Domestic Product. As the government debt is now about $4,000 billions this means that a deficit that averages between 60 to 120 billion dollars per year is consistent with a decline in the burden of the debt. The structure of taxes and public spending should be so constructed that the budget is either in surplus or the deficit is less than 120 billions when the economy operates at a close approximation to full employment.

Measured unemployment is now 7.5%. A measured unemployment of 4% is a reasonable policy objective. A standard rule of thumb is that a 1% point reduction in unemployment leads to a 3.5% increase in gross domestic product, so that the 1992 Gross Domestic Product was some 10% lower than the full employment GDP. In 1991 our gross domestic product was $5,700 billions which makes $6,3000 an approximate number for full employment. A structure of government spending and taxes that results in a government deficit in the neighborhood of $160 billions in 1993 (4% of the accumulated debt, 2.53% of full employment GDP) for 1993 may well be consistent with a budget which is lowering the ratio of debt to Gross Domestic Product and which would lead to a drastic reduction in the burden of the debt if full employment is achieved and sustained for several years.[13] A fiscal posture of this sort, combined with a monetary and debt management regime that is supportive of lower long term interest rates, is most likely the fiscal posture that is apt during the first Clinton years.

The shape of government spending and of taxes needs to be restructured in an effort to make a current deficit in the neighborhood of $160 billions in 1993 a handmaiden to expansion and not merely a sustainor of unsatisfactory performance. Clinton's post inauguration supplementary budget message should include some $50 billion ($200 per person) of grants in aid to the States to be used to undo cuts in State and Local spending on law enforcement, education and infrastructure investment. This program of grants in aid should be permanent.[14]

Perot has put the revenue structure of the government on the agenda. A gasolene tax of 5 cents a gallon will raise about $5 billion dollars per year and if 5 cents is added every year for 5 years the ultimate yield will add $25 billions to tax receipts in the fifth year. This program of a 5 cents a gallon annual increase may well be carried

---

13. At full employment social spending will be smaller and tax revenues may well be $150 billions greater than what the slack economy generates.

14. One aspect may be to require that 20% of every state's grant should be used to develop and implement a series of serious high schools with very high academic standards.

through until the tax is 50 cents a gallon: at that rate it would fund a permanent infrastructure transfer to the states from the Federal Government.

The talk about free trade is mainly cant. We now have a protectionism that is much more harmful to our competitive position than tariffs: an exporter administered quota system, which is what we now have is much worse than a simple straight forward tariff for revenue. This is what we now have for automobiles, transistors and many other products.

Our total merchandise imports are running at $500 billions a year. An immediate 10% to 12.5% flat tariff on the value of all imports, accompanied by a phasing out of all exporter administered quantitative quotas over a 5 year period, is better in terms of free trade than what we have now. Such a tax may yield some $50 to $60 billions in revenues each year, as well as partially protect American jobs.[15] The present government revenue from tariffs and fees runs to about $8 billions.

When fully operational a gasolene taxes and a tariff for revenue will add some $75 to $100 billions to the revenue of the United States governmetn.

---

15. The principles of a free trade zone require a uniform, easily administered common barrier by the countries within the free trade zone to trade with the world outside the free trade zone. A tariff for revenue at the modest suggested rates is just such an easily administered common barrier.

The campaign stressed a middle class tax cut that was revenue neutral because it was offset by a rise in the rate at the higher brackets. This promise should be implemented by a rise in the marginal rate where it now falls and by the introduction of two new rates: a 36% rate for taxable income in excess of $200 thousand and a 40% rate for all taxable income in excess of $1 million, all for a family of four.

The combination of a sanely progressive income tax, a gasolene tax and a tariff for revenue will do wonders to the overall revenue situation. It should also improve the credit worthiness of United States long term securities in the international markets and lower the interest costs of carrying the Government debt.

Employment

Putting the banking and financial structure in order and getting the revenue system back on a path where a close approximation to a balanced budget at full employment can be attained will make it possible for the United States to have a full employment economy based upon private demands in the longer run. Such financial system institution building and revenue system reforms will not do much to improve the situation in the political time span, in which the 1994 Congressional elections are just around the corner on inauguration day. Measures that have a quicker effect on employment are both economically sound, socially desirable and politically necessary.

There are two sets of numbers which point out the need for a direct government employment schemes. The need to contain not the direct dollar costs but the much more serious social costs of welfare dependency mean that some 1.5 million employment oppertunities have to be created for those on welfare. The estimate that there are 10 million young men and women who are not in school, not in jail, not in the army and not working means that there is a tremendous need for job creation.

If we are to achieve a serious improvement in the employment situation in the near term and a close approximation to full employment as a permanent feature of our economy we need to construct modern equivalents of the trio of project based work programs of the New Deal, CCC, WPA and NYA. Two principles motivate such work programs: an abhorrence of the dole and the importance of income from work as supporting the dignity of individuals. The first aim of an employing America program should be to assure that every American has a job which pays at least the minimum wage.

The CCC was one of the great successes of the New Deal. The Conservation Corps was managed by the army. We can once again use the NCO corps and Junior officers to help train youth for work and manage projects. A CCC will open vista's of what can be better to many who are now trapped in a cycle of poverty.

NYA (The National Youth Administration) was a campus and community work program for youths in secondary schools, colleges and Universities. The jobs were only loosely need based. They paid for work in the schools and in community facilities such as playgrounds and neighborhood centers. They taught that income was received in an exchange and not as a dole. The program also was an effective aid to education and even to research.

The revived and modernized Works Project Administration is needed not only to put those who are now on the dole (welfare) to work, but to provide much in the way of improved goods and services to the present poor. WPA can provide supplementary labor to schools, hospitals, park systems, etc. It can build public facilities like swimming pools, tennis courts, etc.

The annual income at the minimum wage is less than $9,000 per year. The adult programs should be at the minimum wage: the youth programs, especially the in school and summer programs can be at a sub minimum wage. It is best if such programs be only loosely means tested. The direct cost of a million WPA workers will be but $9 billions. If 50% is added for material and administration a million worker WPA will cost $14.5 billions per year. The same back of the envelope may well apply to the CCC. In other words less than $30 billions per yesr, less than 1/2 of 1% of GDP will fund programs that will offer jobs and opportunities where non exist now. If the NYA summer and in school programs are funded at $10 billions then the total of the three will be about $40 billions. The total cost of the programs will be less than what the tariff can be expected to yield.

The trio of WPA, CCC and NYA do not need to have long lead times. They could easily become operational by the end of the second quarter of 1993. The CCC would build up: an enrollment of some 80,000 a month would build up to a million in the program by the time it is one year in being.

These programs that yield a minimum wage income open to all should have a beneficial effect beyond that of the money income that employees earn. Our standard of life is based upon that which our private income purchases and the environment in which we live. The prior argument with respect to growth is reenforced when the deterioration in the provision of elementary public goods like safety, schools and health services are taken into account. To the extent that the combination of WPA, CCC and NYA provide incomes in kind to all our people the standard of living associated with any level of private income increases.

Furthermore programs like WPA, CCC, nad NYA bring income and increase demand in our impoverished communities. They should have a substantial multiplier effect within these communities so that the total benefits exceed the benefits measured by the private dollar incomes of the employees of these programs.

Conclusion.

The end of the cold war releases a great deal of competent people from both our military industries and the armed forces. Over the next five years we can deploy millions of workers to produce goods and services which can lead to serious improvements in our standards of life. Many of the released workers have the skill and training to be entrepreneurs. A supportive banking system, which includes new institutions such as the previously mentioned Community Development Banks is a prerequisite for releasing these energies.

The new taxes on imports and gasolene will assure financial markets that the United States is serious about doing something about its deficit and debt situation. A rational fiscal program which cuts the reliance on the income tax and which aims to reduce the size of the debt relative to gross domestic product will also tend to decrease long term interest rates. The burden of the debt is lowered in two ways by both the reduction in the relative size of the debt and the interest rate on the debt.

One formidable task of the Clinton administration is to raise workers morale and constrain money wages even as a full employment policy is put in effect. To do this an improvement in the quantity and quality of the consumption services provided by the government sector is necessary.

It is ironic that The New Deal, which emphasized the virtue of work and employment, survives in the form of transfer payment schemes such as Social Security and aid to families with dependent children. Chronic and systemic unemployment, that relegates all too many to the scrap heap of the economy, is the true measure of the failure of the American Economy. THe true crime of the 1980's and the early 90's is that the number so relegated has increased and is still increasing.

The simple truth we have to face is that the free market system in its present form is unable to guarantee that a close approximation to full employment is the normal condition of the economy. Aggregate demand for labor often and systematically falls below that which is sufficient to guarantee full employment.

There is a need for permanent instruments of policy which generates an infinitely elastic supply of jobs doing work that is useful. The desirable situation is that at every moment of time the number of unfilled jobs is greater than the number of unemployed. This can only be guaranteed if the government acts as an employer who has a vast amount of projects that need to be done and is willing and able to pay to get these jobs done.

There is a complementarity between the needed measures to restructure the financial system, the rebuilding of the revenue base of the government so that the payment commitments on government obligations are met by revenues from taxation rather than by issuing debt to pay debt, spending on infrastructure and improved education and the fallback work based government employment programs. The Clinton program needs to combine those measures such as the CCC, NYa and WPA which have a quick and visible impact and the measures which are needed for a permanent structure of prosperity such as a financial system that is not specialized to the "big deal" and a tax system that yields the revenues needed to finance government spending and to validate the government debt.