The Evolution of the Financial Crisis

Cantillo, Andres

University of Missouri Kansas City

15 December 2009

Online at https://mpra.ub.uni-muenchen.de/49787/
MPRA Paper No. 49787, posted 13 Sep 2013 07:58 UTC
The Evolution of the Financial Crisis

By Andres F. Cantillo

Abstract: Munkirs’ notions of Centralized Private Sector Planning and its derivations are very useful in order to give an alternative explanation to the most recent economic crisis. The crisis is the result of the clashes between the old CPSP and a new one based on recently created technology and financial companies. The old CPSP tried to defend itself by prompting the government to lower the interest rates at the beginning of the 2000s. However, these policies did not solve the institutional tensions. Competition for financing and markets between the old and new CPSP degenerated in financial deregulations and economic policies that ultimately led to the financial crisis. Evidence of the resultant mergers and changes in economic power by key companies in the CPSP is provided.

JEL Classification: B520, E20, L160

Key words: Evolutionary, Evolutionary Economics, Neo Institutional, Interest Rates, Industrial Organization and Macroeconomics: Industrial Structure and Structural Change; Industrial Price indices.

1. Introduction

The aim of the present paper is to provide an explanation of the financial crisis that exploded in 2008. Munkirs’ explanation of the Centralized private Sector Planning (CPSP) is a useful tool in order to understand the changes that have occurred in the US. financial sector. Munkirs approach is based on the analysis of ownership relations amongst companies. By using this framework I propose that the financial crisis was caused by the interstital adjustment produced by the clashes between new technological companies and the CPSP formed by the traditional ones.
The low interest rates registered at the beginning of the 2000s and the deregulation of the financial markets were a consequence (rather than cause) of the conflict between technological change and the existing ownership relationships. The new technology companies have gained a great portion of the market power. The market as such has not increased as a consequence of the new information technologies. This caused the technological boom and crisis at the end of the 1990s.

The old CPSP used the government through its ideological and lobby influences. This caused a reduction in the interest rates that maintained the demand in the industries of the old CPSP. In addition, the deregulation in the financial market allowed companies of the old Central Planning Core to increase its influence in the financial market.

Therefore, the only long run solution is that the government channels the new technologies towards the creation of new markets, so that the technological change does not enter in a destructive conflict with the development of the US economy as a going concern.

2. Theoretical approach
According to Munkirs (Munkirs, 1985) the current institutional structures of the American capitalism are the result of a cumulative change in the economic institutions. Hence, American capitalism is not a free market structure based in lasses faire, but a system of Centralized Private Sector Planning or CPSP. This transformation occurred according to Munkirs, in a period of about forty years between 1865 and 1905. In this period the ownership and economic decision making passed from single firms to trusts and holdings.

“These two new organizational forms were merely legal mechanisms created to eliminate competitive market structures” p 12 (Munkirs, 1985)
These two devices allowed the owners of the firms to expand their intra and inter industry control. In this way, the social decisions of production and distribution were concentrated.

The use of Munkirs’ analysis is based on the following categories:

**Building blocks:** Corporations and industries that are part of the CPSP.

**Interstitial elements:** Several planning instruments that are used confidentially to bind the building blocks together in a coherent production and distribution system.

**Central Planning Core (CPC):** Formed by those industries that engage in the decisions of production and distribution of goods and services. In 1985 when Munkirs conducted his empirical analysis, these companies were seven banks: Citicorp, The Chase Manhattan Corporation, Manufacturers Hanover, J.P. Morgan and Company, Chemical New York Corporation, Continental Illinois Corporation, and First Chicago Corporation. In the insurance companies’ side we there were four of them: prudential insurance Company, Metropolitan Life, Equitable Life Assurance, and New York Life), and one diversified institution: Continental Corporation.

“More specifically, the CPC is a tightly bonded and cohesive group of institutions that functions as a vehicle for organizing and coordinating the production and distribution activities between and among various industries.”p53

**Centralized Private Sector planning:**

“In terms of a definition, then, CPSP may be viewed as a process whereby the production and distribution activities of the economy’s key corporations and industries are organized and coordinated so as to bind
these corporations and industries together into a functionally integrated production and distribution system” Pg. 60

Planning Instruments: They can have two forms: 1) Formal and/or legally binding instruments, 2) informal and/or influential planning instruments.

Formal Instruments: 1) Corporate Stock, 2) Corporate boards of directors and 3) Corporate debt.

Board of Directors (BOD) intralock: Intersection of board members within the same Industry

BOD Interlock: Intersection of board members across different industries

Indirect BOD intra/Interlock: Control acquired through the CPC.

According to Munkirs, the aim of this explanation is:

“...to establish the importance, gravity, and magnitude of the decisions now made and powers now exercised by corporate leaders in the centrally planned sector.” Pg 1684

On the other hand, the role played by the CPSP is described by Munkirs in the following way:

“...that certainly, the traditional concerns addressed in the market system literature pertain primarily to resource allocation, efficiency, and abnormally high profits, are extremely important, but that the autarchic powers inherent in the economy’s centrally planned sector represent a quantum leap, and, indeed, challenge the very essence of the nature of our concept of a democratic society” (Munkirs, The Transformation of American Capitalism, 1985) p 1685

The CPSP has two main ways through which it influences the economy according to Munkirs: Market ideology and selection of government officials in the centrally planned sector. This type of intervention...
renders the rational economic models insufficient in order to explain the complexity of the crisis. This prompts Munkirs to assert that:

“The divergence between societies through epistemological and cultural heritages (Instrumental/technological versus a priori ceremonial) has become so great that rational action is now beyond the community’s reach.” Pg1701 (Munkirs, 1985)

This provides a better explanation for the demise of the economic models mentioned by Alan Greenspan discussed in a further section. In the next one I will provide the set of hypothesis inspired by what has been said hitherto.

3. The main question:

The main question then is what caused the interstitial adjustment that disturbed the Central planning core in such a way that produced the financial crisis. The economy is not mainly ruled by the forces of supply and demand. The centralized private sector planning accounted in 1987 for 55and 60 % of goods and services (Munkirs, 1985). Thus, most of the explanation of the financial crisis must lie in the dynamics of the CPSP economy.

In his testimony before the congress Allan Greenspan identified the lack of self regulation of the lending institutions as the main cause of the crisis. According to him, this self regulation was supposed to act under the market laws. These situations in conjunction with the mechanisms of commercialization of the subprime mortgages led to an accelerating increase in the home prices. This in turn caused an increase in the value of newly offered securitized mortgages.
In addition, Greenspan asserted that the mismanagement of the date in the financial models prompted an error in the calculation of the risk of the securitized mortgages.

“This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer last year because the data inputed into the risk management models generally covered only the past two decades, a period of euphoria.”  

(Greenspan, 2008)

According to this statement the crisis is a result of a mathematical error in the formation of expectations.

Other type of explanation can be found in the news. For instance, according to The New York Times (2008) the Origins of the crisis can be traced back in the steep decline of the stock market in 2000 after the technological bubble. The FED decided to cut the interest rates. This prompted an increase in the demand for houses. There was a renegotiation of the current mortgages; the quality of the mortgages went down, and there was an increase in the demand for complex mortgage-backed securities. The federal fund effective rate plummeted from 6.4% in December 2000 to 1.73% in January 2002. Lower interest rates were set by the FED in order to protect the economy against a deeper recession.

This is an evidence of the interdependence of the behavior of the economy as a whole, the financial markets and policy decisions. Furthermore, in order to understand this interaction it is necessary to establish the ideological and political origins of the policy makers. In this case, we are interested in Alan Greenspan’s policies.

According to Munkirs (Munkirs, The Existence and Exercise of Corporate Power: An Opaque Fact. Journal of Economic Issues, 1987), the ideological component played a very important role in the Regan administration by spreading the convenience of lasses fair ideology; this ideology, following Munkirs, favors the development of the existent Building Blocks. This is compatible with the fact that Alan
Greenspan was appointed to the New York Federal Reserve District by Regan in 1987 (Wells, 2004). Therefore, it is possible to argue that the decision to lower the interest rate avoiding the consequences of the down turn in the financial markets at the end of the 1990s was the market ideology. This ideology was materialized in the election of Alan Greenspan in the board of directors in the FED. Greenspan, appealing to his ideology made the decision to lower the overnight interest rates. This decision was taken in favor of the existing CPSP because it preferred to lower the interest rates than to regulate the financial markets. In this way, Wall Street could keep operating freely because its problems of liquidity were solved with changes in the interest rate by the FED. But this caused the negative effects stated above.

4. The building blocks of the CPSP and their role:

Munkirs described the CPC with the information shown in table 1. The table shows the ranking that each of those companies occupied in the Fortune 500 index as a measure of their economic power.

| Table 1: Source Munkirs (1985) | Rank |
| CPC in 1978 | 1978 |
| Banking | |
| Citicorp | 2 |
| Chase Manhattan Corporation | 3 |
| Manufacturers Hanover Corporation | 4 |
| J.P. Morgan and Company | 5 |
| Chemical New York Corporation | 6 |
| Continental Illinois Corporation | 7 |
| First Chicago Corporation | 9 |
| | |
| Insurance | |
| Prudential Insurance Company | 1 |
| Metropolitan Life | 2 |
| Equitable Life Assurance | 3 |
| New York Life | 4 |
| Continental Corporation | 10 |

| Table 2: Source Fortune 500 |
| Transformation of the old CPC | Rank |
| Banking | 2008 |
| Citigroup Inc | 1 |
| Bank of America | 2 |
| J.P. Morgan Chase and Co | 3 |
| | |
| Insurance | |
| Berkshire Hathaway | 1 |
| Prudential Insurance Company | 6 |
| Metropolitan Life | 4 |
| Equitable Life Assurance | |
| New York Life | 82 |
| Continental Corporation | |
Table 2 shows how the banking CPC changed as of 2008. This is due to massive merges that occurred between 1990 and 2000. It is worth noting that these merges can be explained by the dynamics of the interlocks. Citigroup is the result of the merger between Citicorp and Travelers. On the other hand JP Morgan is the outcome of the merger between Chase Manhattan Corporation, Manufacturers Hanover Corporation, J.P. Morgan and Company, Chemical New York Corporation and First Chicago Corporation.

On the other hand, in regards to the industries of the CPC, Bank of America is the result of the merger of other banking institutions not identified by Mukirs’ as CPC. In the insurance industry appears Berkshire Hathaway whose owner is Warren Buffet who is considered an odd player in the financial industry.

These variations imply that there has been a fundamental transformation in the corporations managing the CPC, that does not keep the same relationships imposed by the Rockefeller and the Morgan families who ruled the CPC during a great part of the last century (Munkirs, 1985).

On the other hand, looking at the industries of the building blocks it can be seen that new industries specifically related to new information technologies have emerged. This is the case of Microsoft that has vertiginously gained positions in the Fortune’s ranking. In 2000 this company occupied the number 84 in the ranking. By 2008 it occupied the rank 44. Other companies as Berkshire Hathaway, began 2000 in the 64th position, and right now are in the 11th position.

The Dow Jones Index is a weighted average of the stock price of the 30 most reliable and solid companies that participate in that market. Looking at the composition of the Dow Jones, it can be observed that in November 1999 Microsoft Corporation and Intel Corporation began be classified as blue-chip equities, taking the place of traditional companies like Chevron.

Hence, there are new players in the capitalist arena. These new players are the result of developments of new technologies. These new technological companies are transforming the building blocks in the
CPSP. Other players, as Berkshire Hathaway are changing the CPC in the CPSP. Bill gates and Warren Buffet emerged as winners after the tech bubble at the end of 1990s. The losers with the subsequent recession were the Building Blocks and the old CPC and CPSP. With a lower interest rate policy the FED tried to mitigate the impact against the old CPSP.

5. The role of technology in the technological boom and the interstitial adjustments.

My hypothesis is that the lower interest rate gave the opportunity to the building blocks of the old CPSP to join the new CPSP. A way to achieve this was through the creation of new mortgage backed securities in order to delay the interstitial adjustment prompted by the new technological companies. Lower interest rate maintained the demand for traditional goods and services, but the new technological companies had gained a huge share of the market. Some of the losers with these strategies were the international buyers of these derivatives. The new winners had to insert themselves in the new CPSP with the new technological companies incorporated. The demand for new information technologies decreased the demand for the traditional goods. Therefore, the financial market underwent a transformation towards the financing of the newly created technologies. Since this bigger demand for new technology did not create more demand for traditional goods, there was another element of tension. In addition, this new technologies are not increasing the size of the market. Most new products are increasing the consumption of durable goods (like iPhones and the like), but are not doing more efficient production.

According to Fortune (2008) the Computers and Office Equipment was the 8th industry in profit growth from 2003 to 2008 (36.2%), just below oil industries and airspace and defense. On the other hand, motor vehicles and parts have grown 12.8 % and occupy position 21 in the ranking.
In spite of all this, the allowance of derivatives in the financial markets and the low interest rates, maintained the demand for the goods sold by the old CPSP. As a result, the Dow Jones recovered its value from 86607.52 in 2003 to 14164 during 2007. This gave some time to the old CPSP to recover. However it was not enough.

6. Evolution of the crisis:

The first big move in the CPC shown in table 2 was the purchase of Bear Stearns by JP. Morgan Chase. This operation was worth US$236m. The value per share was $2 in March. In January it was $30. This move increased the value of the capital for JP Morgan’s holders. The low capital value of Bear Stearns was clearly caused by its investment in real estate and mortgage backed securities.

In September 15 Lehman brothers declared Bankruptcy after the secretary of the treasury decided not to bail out the bank. Bank of America was interested in buying this bank. However it had to change its strategy and buy Merrill Lynch for $50 bn which later on proved insolvent.

Morgan Stanley was allowed by the Federal Reserve to become a regulated bank. In addition, Goldman &Sachs was allowed by the Federal Reserve to become a commercial bank, losing the status of Investment bank. In this way Goldman and Morgan could have access to the loans given by the government (Financial Times, Dec 22).

Citigroup, previously bailed out by the government, bought Wachovia. In this way the City group became the largest bank retailer in the US (Financial Times, Sept 29).

As we can see, the enterprises in the CPC have been favored by the government policies. The moves on Citigroup and Morgan Stanley show the CPSP acting though the action of the government. For the actual economic system to keep working, maintaining jobs, prices and profits, the secretary of
the treasury received the approval of the congress to bail out certain companies, in this case, those in the CPC. On the other hand the government didn’t bailout Lehman Brothers, taking of the possibility for the new player in the CPC, Bank of America, to acquire it. It is worth noting also, that Henry Paulson was former Chairman of Goldman and Sachs, which shows a conflict of interest in his decision, and is evidence of CPSP in what Munkirs explained as an ideological influence in the government policies.

Lately, the automaker companies were bailed out. This included General Motors and Ford, which were identified by Munkirs as part of the building blocks of the old CPSP.

**Conclusions:**

The evolution of the enterprises in the CPC identified by Munkirs in 1985 shows that the CPSP is a useful explanation of the evolution of the power in the economic institutions of ownership and power in the US. This can be seen in the mergers amongst the banks in the CPC.

On the other hand, new players have entered to take part in the CPC and in the building blocks. In the CPC, it is remarkable the influence of Berkshire Hathaway owned by Warren Buffet. In the building blocks it is worth noting the appearance of new technology enterprises, specially relating with computers and internet. As an example, the evolution of Microsoft in the Fortune’s ranking, and its influence in the stock market is an evidence of this new power. These new players are transforming the old structures of the CPSP based in the Morgan and the Rockefeller families.

The first evidence of this crisis was the tech crisis at the end of the 1990s. The new financial value of the computer and internet enterprises cannot be absorbed by the existing financial market. What is more, it has not been absorbed by the former production and distribution system.
The US government tried in the crisis of the end of the 1990s, to avoid the recession caused by this incompatibility of the technological change with the old CPSP. The FED set down the overnight interest rates, and allowed the deregulation of the financial markets. This maintained consumption for the goods produced by the old CPSP. However, the new technologies of internet, software and computers have not generated enough reduction in the cost structure of the economy. Therefore, there is a tension between the technology of the old CPSP and the new technologies in the struggle for the consumers, and the struggle of financial resources.

The reduction of interest rates caused the delay in the adjustment of this unsolved tension. The sales of mortgage backed securities allowed the old CPC companies to increase their power in the market. Nevertheless, the time was not enough for other companies like the automakers. The aim of the government’s (Veblen T., 1920) bailouts was to give time to the old CPSP to adjust and include the new technological companies. However, unless there is an adjustment between the interlocks of the new tech companies with the old ones, the crisis in the economy will be recurrent.

Therefore, it is necessary that the US government guide the production of new technological enterprises towards the generation of more reduction in the cost of production of products that are being produced in the old technological companies. In this way, the CPSP, although not the best alternative, could become more dynamic.

This show to what extent the new technological enterprises like Microsoft have gained power against the building blocks of the old CPSP.

**Bibliography**


