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## A Reagan Recession or Depression

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In March a minor government bond house in Florida and a small savings institution in Ohio failed. This led to the closing of other thrift institutions in Ohio and a break in the foreign exchange market that knocked some ten percent off of the exchange value of the dollar. In October of 1984 the final collapse of the Continental Illinois Bank of Chicago was triggered by a flight of offshore deposits. These "events", together with others such as the real estate mortgage losses of the Bank of America, make it evident that financial markets are now so closely interrelated that a major "domino effect" collapse is possible.

These financial events together with the inability of the Reagan prosperity to bring unemployment below the seven percent mark raise concerns about the true nature of our economy that have not been addressed since the decade of the great depression. Is our type of economy inherently stable, so that a close approximation to prosperity is its normal state, or is it intermittently unstable, so that from time to time its internal dynamics leads to a serious depression? Furthermore, if the economy's internal dynamics make it depression prone, why haven't we had a serious depression over the forty years since World War II?

These questions are addressed by the financial instability hypothesis, which is a variant of Keynesian economic theory that draws upon Keynes' analysis of finance and speculation. This aspect of Keynes' thought was neglected in the development of the orthodox Keynesian Theory. The financial

instability hypothesis holds that over a protracted period of good times profit seeking actions of bankers and businessmen lead to the financial system evolving so that it becomes an hospitable environment for an interactive (domino effect) financial crisis. Such a crisis can usher in a serious depression. Using the analytical apparatus of the financial instability hypothesis, which concentrates on profit flows and payment structures, it can be shown that a combination of deficits, that big government naturally generates during recessions, and lender of last resort interventions by the "monetary authorities" can contain a financial crisis and quickly turn the economy from a contraction to an expansion.

The financial instability hypothesis also indicates that inflation is a side effect of this process, largely because government raises profit levels and the lender of last resort interventions by the Federal Reserve sustain asset values and flood the banks with reserve money. As a result, during the expansion that follows bank financing of activity takes place at an accelerated rate. Furthermore as recessions are not long and severe, wages tend to continue increasing during contractions. The financial instability hypothesis successfully explains the behavior of the economy since World War II.

Aside from the reduction in the rate of inflation, the course of the economy during the Reagan years conforms to the financial instability hypothesis. The reduction of inflation over these years can be laid to the international strength of the dollar and the breakdown in union strength.

We are now approaching the 2 1/2 year mark of the current expansion. The normal expectation would be that the expansion has another year or so to run, but the financial structure is showing so many signs of potential disturbances and crises that the occurrence, quite soon, of a financial crisis that leads to

a sharp decline in asset values, output and employment must be considered as a distinct possibility. For investors, bankers and businessmen the downside risks may be so great that defensive postures might be in order.

The recent Ohio episode shows the convoluted character of financial relations and how a small event can have serious consequences. The recent revelations of incompetence and/or fraud in the Bank of America [mortgages, Paraguay] indicate that large, complex financial corporations are both very difficult to manage and susceptible to major losses. The financial problems of a number of Texas "billionaires" is a cause for concern, for part of this "Texas" problem is that banks and other lenders looked at the signature on the debt and not at the cash flows of the projects they were financing.

Although in our convoluted financial structure the repercussions of a disturbance can be far from the "source", three possible, and not independent, sources of disturbances now loom large. One is in Texas banks, another is in the complex of offshore, dollar denominated banking and a third is in the debts due to the merger, take over and buy out refinancing that has been so much a part of the recent speculative environment.

Although the Texas banks are viewed as being "oil related" -and the problems that are now surfacing in these banks may be largely due to their financing of exploration and equipment for exploration -these oil losses are likely to be compounded by real estate losses. The Bank of America's recent mortgage losses centered around the valuation of property underlying collections of mortgage bonds. The farm loan problem centers around the value of property. Whenever interest due is not earned but is paid by increasing debt, the question naturally arises about the conditions under which incomes large enough to pay the interest on the increased indebtedness will be earned.

If these conditions become "unlikely" or "impossible" then a "writing down" of asset values and indebtedness to a level that can be supported by incomes must take place.

It is known that there is a sizeable inventory of commercial property in the major Texas cities. If the oil industry complex of the price of oil, oil exploration, market value of rigs etc suffer another decline, then the inventory of vacant commercial property in the cities that are closely tied to the oil industry is likely to increase or its absorption rate will decrease. This can lead to asset revaluation and overt losses, first in the impacted cities and then throughout the economy.

Over the past years the dollar has been appreciating rapidly and there has been a large increase in dollar denominated offshore banking. These offshore bankers have dollar assets and liabilities and maintain a position in "New York dollar assets" in order to meet clearing losses ["New York dollars" are their reserve currency]. If the current decline in the dollar accelerates, it will be because various forms of hot money move out of the dollar and into other currencies. When this happens these offshore dollar banks will need to dump their New York dollar assets so as to buy the other currencies. The Federal Reserve will need to react to downward pressure on the dollar and sharply rising interest rates.

A modest orderly decline in the dollar might be welcomed by the banking authorities. However a decline in today's markets is not likely to be modest or orderly, at some point a run out of the dollar will occur. When this happens the Federal Reserve will move, as in 1979, to push interest rates up in order to save the international position of the dollar.

However, a rise in interest rates to the levels of 1980-82 will play havoc with the ability of highly indebted businesses and households to fulfill

their payment commitments; this will put pressure on the liquidity and solvency of the already weakened banks.

The various financier plays which lead to mergers, take overs and buyouts involve the use of debts - mainly bank debts. For each newly highly indebted organization that results from these events there is a maximum bank interest rate which is compatible with the flow of gross income to the debtors. Any scenario that leads to substantially higher interest rates will see financing deals unravelling.

Given the big and still increasing government, any decline in income that follows from financial difficulties will lead to a large increase in the deficit. This will sustain aggregate business profits. As a result the system is not likely to "collapse" as in 1929-33; but the number of bankruptcies and the number of "asset values" that plunge to "realistic" levels, is likely to exceed that which took place in 1981-82. The income and employment decline and the breadth and depth of the financial trauma of the next recession are likely to exceed that of 1974-75 and 1981-82 even if both the Federal Reserve interventions and the rise in the Federal Deficit take place quickly and are of an appropriate size. But if the Federal Reserve and the Treasury hold back because they still are fighting inflation or because their ideology and economic theory hold that our economy, if left alone will achieve and sustain an adequate level of prosperity, which means that the Federal Reserve sticks to a "money supply target" and the government constrains the size of the deficit by cutting spending or raising taxes, then a second Reagan recession is likely to become the first Reagan depression.

Given the complexity of financial structures and the extent to which the banking authorities are now carrying virtually insolvent financial institutions, there will be a "crisis" and a recession that exceeds that of

1981-82 sometime in the next several years. The only open questions are when and how deep. As recently as the winter of 84/85 it seemed as if the expansion would carry through 1986, because the financial crunch would come later, not sooner. However the recent signs of financial weakness cannot be disregarded. Both participants in our economy, whose well being depends upon the sustaining of prosperity, and economists, who are concerned with the validity of competing economic theories will find this spring and summer very interesting.