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Statement before the Subcommittee on Domestic Monetary Policy of the Committee of Banking, Finance and Urban Affairs of the US House of Representatives

Hyman P. Minsky Ph.D.

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tandem with a system of regulation and control, that constrains the growth of corporate debt. This implies that private business investment by corporations that are bloated with debt will be restrained. Under these circumstances government spending will have to shift from income maintenance via transfers to resource creation. As a corporation succeeds in restructuring its liabilities, so that its equity and short-term debts position is improved, then the constraints on its investment activity should be relaxed. Liability structure criteria for the ability to debt finance need to be developed.

One policy possibility therefore is to impose a permanent system of financial regulation which constrains the liability structures of firms, banks, and other financial institutions and also that which households can use to hold equities. I do not promise that any such structure of regulation will lead to perpetual bliss, but I expect that it could lead to the establishment, for a time, of a closer approximation to full employment and price stability than we are capable of achieving with our present system.

As an alternative, Congress could instruct the Federal Reserve that its lender of last resort powers should be used with greater discretion, that financial collapses such as threatened the Hunts and Bache & Co. in 1980 do not call for intervention by the Federal Reserve. The function of bankruptcy is to induce private financial conservatism. If a big government that is involved in resource creation is in place then deficits will sustain profits. The penalty in economic performance from allowing downside financial instability to constrain debt financing can be contained. Big government may enable us to have financial crises without deep depressions and subsequent stagnation.

Economists cannot offer bliss. Our type of economy cannot be fine tuned to achieve uninterrupted full employment at stable prices. Even though perfection cannot be achieved we can do better than we have over the past 3 or 4 years.

[Mr. Minsky's prepared statement and a statement "Policy Pitfalls in a Financially Fragile Economy," dated October 2, 1981, and delivered at the Third Annual Sewanee Economics Symposium, the University of the South, Sewanee, Tenn., follow:]

Statement by

Hyman P. Minsky

Professor of Economics, Washington University (St. Louis)

before the

Subcommittee on Domestic Monetary Policy

of the

Committee of Banking, Finance and Urban Affairs

United States House of Respresentatives

May 27, 1982

My name is Hyman P. Minsky. I am a Professor of Economics at Washington University in St. Louis. In am also an economic advisor and a member of the Board of Directors of Mark Twain Bancshares, a Bank Holding company which has grown from less than 100 million dollars to almost 1 billion dollars in total assets over the past fifteen years. My remarks draw upon my academic and practical experience, but they are my views and not necessarily the views of my colleagues at Washington University or Mark Twain Bancshares.

I am very happy to share my ideas about the fiscal and monetary questions which now confront us. I have a short prepared statement. After a general introduction I address the four questions put by Chairman Fauntroy in his invitation.

My distinquished "colleagues of the day" Allen Sinai, Richard Scott-Ram and Donald Maud are drawn from the practical world of consulting and Wall Street. They are much better equipped than I am to discuss current and recent numbers and ongoing institutional developments. I am an academic monetary theorist. I am not from one of the dominant streams of today's economic thinking for I am neither an orthodox Keynesian, a monetarist or a supply sider. I feel I belong to the mainstream of monetary business cycle theory, which has a long tradition but which was brushed aside as excessive mathematization and an unwonted reliance on econometrics dominated economics. Keynes's General Theory, which is quite different and much more subtle than the doctrines that are called Keynesian is a key work in this tradition. Because I, and others who work along similar lines, acknowledge the importance of an unorthodox interpretation of Keynes in our work, we are often referred to as Post Keynesians. I am attaching a forthcoming paper which may help explain my views as a theorist.

From my perspective the central problems that theory must explain are accumulation and the evolution of the economy in response to profit opportunities. Standard theory - whether orthodox Keynesian, monetarist or supply side - rests upon fundamental constraints that were designed to explain why a decentralized market economy can yield coherent outcomes. The alternative theory aims to explain why one economy is richer or poorer than another and why an economy becomes richer or poorer. In this view explaining business cycles is the central concern of theory. In recessions our type of economy becomes poorer even though the technical ability to produce is not changed. The aim of theory is to explain why intermittent depressions are a normal result in our type of economy. Once we understand the processes that lead to depressions it may be possible to develop programs that can contain the thrust towards depressions. I will first characterize our type of economy and then draw some inferences about how our economy functions from its history since World War II.

Our economy is now an interventionist capitalist economy with complex financial structures that has a government whose spending and taxing are large relative to national income. Prior to the New Deal, our economy was a largely non-interventionist capitalist economy with a complex and convoluted financial structure that had a government whose spending and taxing were small relative to national income.

The small government capitalism that ruled prior to the New Deal was subject to recurring serious depressions; the great depression of 1929-33 was just a grand example of the recurring hard times. Even though real progress in per capita income and wealth took place through our history, we really did

not get a deep and thorough payoff from economic progress until after World War II. The twenty years following the end of World War II (say from 1946 to 1966) were the best years the American econommy ever experienced. Without trying to explain why these years were so good, it is clear that during this period the American economy achieved a closer approximation to full employment at stable prices for an extended period of time than it achieved either prior to World War II and since say 1970.

In our economy debt is used to finance business activity, household expenditures and government units. There are complex sets of institution which issue debt in order to acquire debt. The critial and essential attribute that makes our economy capitalist is the use of debt to finance both the ownership of capital assets and economic activity.

Debt sets up commitments to pay cash. These cash payment commitments are on account of both the "principal" owed and "income" i.e, interest. If we use the loan relation between banks and business as a model of the indebtedness process, we note that whenever a business goes into debt to a bank the business and the bank agree that as a result of various types of transactions the business will be able to pay off the debt and pay the interest that is in the contract. The ability to go into debt rests upon the profits the business expects to make. For a business to go into debt to acquire or to operate assets, the business borrower and the banker lender must agree that that profits will be large enough so that the business man will be able to fulfill the commitments on the debts.

There are two sources of cash (we ignore the trivial case of "cash on hand") to pay debt other than gross profits flows; these are "borrowing" or "rolling over" debt and selling assets. In my arguments I have identified three debt profit situations; (1) profit flows meet all interest payments but not all of the

principal that is due and the expectation is that in the future profits will be sufficient to repay principal. I call this speculative or rollover finance, (3) profit flows do not meet interest or principal repayments, so that interest has to be capitalized i.e., added to the debt. I call this Ponzi finance.

Bankers are merchants of debt; financial organizations are profitable exactly as they instruct business in the use of debt and as they invent liabilities which are attractive assets for owners of wealth or holders of transitory liquidity. Finance is now and has always been an arena for innovations.

At the end of World War II private business of the United States had extraordinarily low ratios of debt to liquid asset and payment commitments on debt to profit flows. This liquidity, the lingering of fear induced by the great depression and a fiscal conservatism, which led to an apt expenditure/receipts relation for the Federal Government, were the basic ingredients for the prosperity of the 1950's and early 60's. However, over this period, the liability structure of business - and of financial institutions changed: The ratio of debt to liquid assets and payment commitments to profit flows increased.

The phenomena we call a crunch depends upon the existence of a sizeable structure of short term business and financial institution debt which needs to be rolled over if the commitments on the debts are to be met. Without a substantial volume of speculative finance that can become Ponzi finance with a rise in interest rates, a crunch is not possible. If a crunch is not offset by an infusion of refinancing, either by banks acting in concert or by the Federal Reserve, then a panic induced rise in interest rates, a sharp fall in asset values and a liquidition of asset holdings (financial and real) would take place. Unoffset financial crunches that led to debt delfations were regular events in the century prior to World War II. Even Friedman & Schwartz's history shows that deep

depression cycles were associated with financial crises: These crunches that were not offset by Federal Reserve intervention, so that a debt deflation took place, were part of the process that led to serious depressions.

We have had crunches in 1966, 1969/70, 1974/75, 1980 and perhaps last week. In each case the crunch was associated with a decline in the economy - a decline in growth in 1966 and bona-fide recessions in 1974/5, 1980 and now. In each case the Federal Reserve intervened to protect the markets (and even the individual units) that were at risk. As a result of the refinancing and infusion of liquidity, no interactive debt deflation took place.

The crunches were associated with a decline in income due to inventory liquidation and a fall in investment. However in our big government capitalism, a decline in income and employment with the tax and spending programs in being at the time led to a huge deficit. This deficit sustained business profits (business profits in a closed economy under "heroic" assumptions, which nevertheless do not do violence to the process involved, equals investment plus the government deficit). As a result business was able to reduce its indebtedness and fund some of the short-term debt into long-term debt. With interest rates down, investment at a slow pace and profits sustained business retained earnings increased; internal funds increased business equity thereby reducing the ratio of debt to equity. Financial recovery was a prelude to economic recovery.

The combination of lender of last resort interventions and massive government deficits aborted thrusts toward a serious depression in 1969/70, 1974/5 and 1980. But the world learns and medicine loses its effectiveness. The distortation of the budget to a permanent larger deficit in 1981, the end, for the time, to the long-term

bond market because of losses due to exploding interest rates, and the decline in equity prices, because debt exposure makes equities much more hazardous, means that the recovery from our current malaise will not be as quick nor as successful as from the prior recessions. We are neither on our way to another great depression nor are we on our way to a recapture of the golden era that ruled for some two decases after World War II.

I will now turn to the specific questions raised by Chairman Fauntroy in his letter inviting me to testify.

1. As you know, many businesses are carrying a high proportion of short-term debt relative to both equity and long-term debt. Why has this situation arisen?

The high ratio of short-term debt to both equity and long-term debt is a result of the evolution of liability structures and financial practices since World War II combined with market developments which "force" units into short term financing. Basically the current stituation, or an approximation to the current situation, is a normal result of business and bankers using their available liquidity to exploit profit opportunities. We should expect our businesses and bankers to carry no excess liquidity, given their assessment of risks and uncertainties. Unfortunately market assessments of risks involved in financial structures are often in error.

Short run developments which have exacerbated the long run situation are:

1. The disappearance of the long term bond market. This reflects the losses bond buyers have taken as interest rates increased. Recent experience has shown that fixed interest rate lending is bad for lenders.
2. The rise in interest rates and in business debts means that a smaller portion of gross capital income is available for retained earnings, especially as the market and management of publically owned corporations values stability in dividends over stability in the growth of equity by means of retained earnings. Equity now grows at a lower rate because of the decline in retained earnings.

3. The depressed equity market, because of reasons cited above, has depressed new equity issues; business cannot readily raise equity funds by floating new issues.
4. The growth of short-term debt because a sizeable portion of business are "walking bankrupts" who are capitalizing interest, i.e., walking bankrupts cannot pay debt or pay interest due so bankers add the "unpaid" interest to the outstanding debt.

2. What is the status of corporate liquidity at present because of this situation?

My colleagues in testifying today are in a much better position to discuss the numbers than I am. From my theoretical discussion , it is evident that I feel that economically significant meaning of liquidity is the relation between cash payment commitments on liabilities and the cash flow or gross profits inclusive of interest but after taxes of business. High interest rates transform hedge units into speculation units, speculative units into Ponzi units and Ponzi units in covert (walking) and overt bankrupts. As a result of today's covert and overt bankruptcies we can expect that the recovery will be slow once interest rates turn down and profits are increased by an exploding deficit, for businesses and banks will move to rebuild liquidity before they take advantage of the lower rates to finance investment. Profit flows will depend upon the maintenance of high government deficits for some time. The budget posture needs two attributes (1) a high deficit is needed now to sustain profits and facilitate an improvement in bank and business liquidity and (2) a tax and spending program in being such that at a believable level of economic performance (say a 6% unemployment rate) the budget is in surplus.

3. How has the continuing strong corporate demand for short-term credit affected the growth of the monetary aggregates, and how has current monetary policy affected short-term credit conditions?

Continued strong corporate demand for short-term credit is largely due to the capitalization of interest, the inability to fund short-term debt into long term debt and the slow growth of equity due to internal funds because of high interest payments. In good part the Federal Reserve is not able to correct the situation.

By a rapid expansion of its outstanding credit the Federal Reserve could try to force a sharp reduction in short term interest rates. However, unless this expansion is a lender of last resort emergency intervention this would rekindle inflation fears so that (1) long term rates would not fall , (2) the availability of long term financing would not increase and (3) a sharp fall in the dollar on the exchanges as well as a drain of foreign holdings from U. S. money markets would occur. The Federal Reserve would then be bound to back off from the attempts to increase the money base.

I do not believe that the Federal Reserve or monetary policy were the basic causes of the situation in which we find ourselves <u>except</u> to the extent that the Federal Reserves intervention as a lender of last resort in 1969/70, 1974/75 and 1980 both prevented more serious declines in income than we in fact had at those times and set the stage for the subsequent inflation and high interest rates. Our current predicament is a side effect of the sucessful interventions that prevented a serious depression in 1974/75 and perhaps in 1980.

4. What monetary and fiscal actions should and should not be taken to prevent current liquidity conditions from deteriorating and reaching crisis proportions?

There is no quick fix or gimmick that will put us out of the current situation. We know that in the past we floated liquidity constraints off by an inflationary monetary policy in tandem with an inflationary fiscal policy. In 1974/75 the combination resulted in a four year expansion that culminated in

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double digit inflation, double digit interest rates, and a very fragile financial structure. Given that market participants learn, any attempt to replay the 1974/75 policy scenario will lead to a quicker acceleration of inflation and interest rates and a more rapid deterioration of liquidity and solvency than we experienced in 1975-79.

We need the financial restructing that takes place during a great depression - including the inducing of balance sheet conservatism by losses - without a great depression. One way to achieve this is to run a large government deficit which sustains profits, in tandem with a system of regulation and control that constrains the growth of corporate debt. This implies that private business investment by corporations that are bloated with debt will be restrained. Under these circumstances government spending will have to shift from income maintenance via transfers to resource creation. As a corporation succeeds in restructuring its liabilities, so that its equity and short-term debts position is improved, then the constraints on its investment activity should be relaxed. Liability structure criteria for the ability to debt finance need to be developed.

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Policy Pitfalls in a Financially Fragile Economy

Hyman P. Minsky

Professor of Economics

Washington University, St. Louis

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