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The Fragility of the Financial System and the Near Term Prospects of the Economy

by

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The forecast by the President's Council of Economic Advisors for 1974, that the first half of 1974 will see no growth or a mild recession, accompanied by rapid inflation, while the second half will witness a resumption of growth and an easing of inflation, is very tentative. The tone of the forecast is humble. This humility stands in sharp contrast to the self-assured if not arrogant tone of the Council in both the earlier Nixon years and the Kennedy-Johnson era. Of course, given their forecasting record, the administration economists have much to be humble about.

After noting that their forecast is feasible (whatever that means), the Council delivers the warning that the economic future is "uncertain to a significant degree." One cause of the uncertainty is the politically motivated oil embargo. But there is another deeper reason, in aspects of the economy that the Council ignores, for taking their forecast with the proverbial grain of salt. The slowdown of the economy is taking place within a financial structure that is substantially more fragile than it was earlier in the post-war era. As a result of the financial fragility the slowdown may trigger financial dislocations. If such financial dislocations take place the down turn will be both more serious and last longer than anticipated

The Council's forecast for the first half of 1974 should be taken more seriously than its forecast for the second half. The forecast for the first half is mainly based upon observations on the economy, the forecast for the second half is largely based upon their economic theory. The school of economists to which the Council members belong, believe that deviations of the economy from a non-inflationary growth path are mainly due to prior disturbance from outside the internal workings of the economy. They further believe that if no further outside disturbances occur, especially if monetary and fiscal policy are not disruptive, then the economy will quite quickly return to its normal growth path.

The economic theory underlying the Council's forecast is under serious attack from economists who hold that non-inflationary growth is a transitory, not a normal, state of the economy. These economists hold that financial and wage price processes tend to move the economy away from self sustaining non-inflationary growth. In these economists' views, stability is in and of itself destabilizing.

One variant of these views holds that the internal workings of the economic processes generates conditions conducive to financial instability. As a result, these economists look at and emphasize data on the financial structure of the economy that are ignored by the standard school which underlies the Council's forecast.

American economic history from the birth of the Republic to the great Crash of 1929-33 is replete with financial crises. Between the Depression of the 1930's and 1966 no events remotely resembling a financial crisis occurred. The credit crunch of 1966 and the Penn Central - commercial paper market dedevelopments of 1970 were miniature financial crises. In both instances prompt action by the Federal Reserve prevented the initial disturbance from triggering a full-fledged financial crisis. Even so these mini-crises led to slowdowns of the economy -- a pause in 1967 and a recession in 1969-70. Furthermore, the actions taken by the Federal Reserve to abort a possibly serious crisis had the unwanted side effects of setting the stage for a renewed inflationary thrust

Detailed data about the financial structure of the American Economy appear in the Federal Reserve's Flow of Funds accounts. This information about income flows, assets, and liabilities for various sectors is now available for the entire period since the end of World War II. From the data in the Flow of Funds accounts, it is possible to construct indices which measure the relative fragility of the financial structure.

The relative fragility of the financial system can be estimated by looking at the cash flows of households and non-financial corporations relative to their debts, and at the relation between liabilities and secure financial assets for various sectors. By all these measures a sharp increase in fragility took place between the end of World War II and the time of the credit crunch in 1966. For many measures this trend pointing to increased fragility has continued to date.

For the non-financial corporate sector the ratio of liabilities to gross profits after taxes stood at 5.6 in 1949. This rose to 6.3 in 1966 and stood at 8.5 at the end of 1972 (the latest date for which Flow of Funds balance sheet data is available). For households the ratio of liabilities to disposable income rose from .34 in 1949, to .73 in 1966 and has remained at or above .73 since 1966. It is clear that the danger that firms and households may not be able to fulfill contractual obligations out of cash flows, if profits are sharply cut or if unemployment is prolonged, is now substantially greater than earlier in the post war period.

An alternative to paying debts out of cash flows is to pay debts by drawing down on cash or marketable financial assets. For the non-financial corporate sector the ratio of liabilities to the sum of demand deposits, time deposits and Federal government debt rose from 2.7 in 1949 to 7.1 in 1966 and stood at 10.4 in 1972. For households the ratio of liabilities to the sum of Federal government debt and deposits at banks and savings institutions was ~~3.4~~ .34 in 1949. By 1966 this ratio rose to .76 and it stood at .72 in 1972. Thus for both non-financial corporations and households, the fragility of the financial system as measured by assets which can be drawn down to meet debts is now substantially greater than at the end of World War II and somewhat greater than in 1966.

Data on the financial sectors also indicate that the financial structure is now more fragile than earlier in the post-war period. Commercial banks are the heart, and presumably the most secure portion of the financial structure. Over the post-war period, the ratio of no default assets (cash plus Treasury securities) to total assets in the portfolios of commercial banks has fallen from .61 in 1949 to .16 in 1972 and the ratio of purchased money (negotiable certificates of deposit, eurodollars, and federal funds) to total assets has risen from .03 in 1949 to .19 in 1972. These trends within commercial banking have been accompanied by a large growth in fringe financial markets such as the commercial paper market and the real estate investment trusts.

The above is but a small sample of the data which indicates that the financial system is now substantially more fragile than it was earlier in the post-war period. Although this greater fragility does not guarantee that a financial disturbance will occur, it certainly indicates that there is a clear danger that one might occur. The possibility cannot be ignored that the downturn in income in 1974 may trigger financial dislocations such as occurred in 1966 and in 1972.

In these prior mini-crises, the Federal Reserve acted promptly to offset the destabilizing movements, they succeeded in aborting the incipient serious financial crisis. However, the Federal Reserve has been blamed for the later inflationary bursts. This may now make the Federal Reserve less prompt in responding to a threat in 1974 than it was earlier.

In any case, regardless of whether the Federal Reserve responds promptly or with a lag, the development of even a mini-crisis during 1974 will assure that the second half of 1974 will be worse not better than the first half -- and that at best 1975 will be a year of stagnation.