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The United States' Economy in the 1980's:
The Financial Past and Present as a Guide to the Future

"Economics in the Eighties" Conference
Palazzo Della Spelline - Milan

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Economic forecasting is always treacherous, but forecasting is especially difficult in an era of political and social turbulence. The wide-ranging events of the past several years, such as the revolution in Iran, the war in the Persian Gulf, the workers' movement in Poland and the sharp swing towards the right in the United States, are evidence that the political and social conditions, within which the development of the United States and the world economy will take place this coming decade, are among the class of phenomena that Keynes labeled as uncertain. As Keynes put it for such phenomena, "...there is no scientific basis on which to form any calculable probability whatsoever."[1] Because of political and social developments and the behavior of various classes of economic variables, events in economics are "uncertain" rather than "risky" for the probability distribution of alternative possible outcomes are not known.[2]

Even though forecasting is full of pitfalls, forecast we must. This is so not only because commitments are made to give talks such as this, but also because investing and financing units, which commit money capital to acquire particular capital assets, forecast. Investing businessmen and their bankers forecast that cash will be forthcoming from using capital assets over the years ahead so that the payment commitments that are stated in the financial instruments being used to raise money capital will be fulfilled. The pace of investment, liability structures of ordinary business and financial institutions, and prices of financial and capital assets are observable variables that reflect views about the future. In a capitalist economy with complex, sophisticated and evolving financial markets the present views about the future are evident in the prices on markets of capital and financial assets and in the terms of the financing that is taking place.

Even as we accept that political and social parameters change in ways we cannot hazard to forecast, we can identify current economic phenomena and relations that "set a plot" that will be "acted out" in the eighties. This "plot" is set by economic and financial variables and relations that are legacies of the behavior of the economy over the post-war era, the years since 1945. These legacies can be interpreted as initial conditions from which dynamic interactions begin. To understand these initial conditions requires both a knowledge of economic history and an economic theory that incorporates financial processes in the main body of the theory. Unfortunately the standard economic theory of our time, which takes both monetarist and standard Keynesian colorations, is not a good framework for dealing with the financial interactions that are so important in determining the performance of advanced capitalist economies.

One reason for the poor performance of the American economy over the past fifteen years is that the input from the "policy advising establishment"--both monetarists and Keynesians--has been based on an economic theory that fundamentally misspecifies the processes at work in the economy. You cannot cope with a problem which you do not understand. The economic theory of the policy advisors of both the incoming and the outgoing administrations treats the financial structure and performance of the economy as "peripheral" rather than as core phenomena. To understand and successfully cope with the problems the American economy will face in the 1980's it is necessary to start from an economic theory which fully integrates financial legacies and behavior into its explanation of system behavior. In such a theory the basic economic problem is not the allocation of given resources among alternative uses as standard economic theory has it; but rather it is the creation of resources. In a capitalist framework this means that the financing of investment and control over capital assets are main determinants of system behavior.

Although all of economic life is an evolutionary process in which changes in institutions and usages change system behavior, in the post-war era financial institutions and usages were a particular "focus" of rapid institutional change. Because of the rapid changes the significance of various observations such as interest rates or specific definitions of "money" changed over these years. This means that econometric analyses and theoretical models that ignore institutional evolution are more misleading than enlightening. There is no significant body of empirical work on money and finance which stands the test of giving consistent results for 1945-65 and 1965-80; generalizations born of statistical studies have little value in explaining the behavior of the American economy.

To many the conflict among economic theories is between so-called monetarism and what is called Keynesianism. In fact both monetarism and standard Keynesianism are neo-classical theories. Neo-classical theory takes as its "basis" notions of market behavior which are extensions of barter arrangements and treats investment and the financing of investment as if they too are variants of bartering. There is an alternative to this standard theory--it is poorly labeled as Post-Keynesian economics--which insists that to explain how advanced capitalist economies behave it is necessary to fully integrate financial and financing relations into the theory. Thus to understand the problems the United States will face in the '80's we need to understand its financial past and present.

The thirty-five years since the end of World War II can be divided into two parts. The first, which ran from the end of the War to the mid-sixties, was an era of on the whole financial tranquility. The second, which began in the middle sixties and is still with us, can be characterized as an era of increasing financial turbulence. The era of financial tranquility was associated with on the whole steady progress. The years from 1946 through 1965 might well be "the best years" that the American economy ever enjoyed.

Beginning in the middle 1960's the economy became increasingly turbulent. Inflation at accelerating rates, a chronic deterioration in measured unemployment rates, a slowdown in the rate of increase of measured economic growth, interest rates that are increasingly volatile and follow a rising trend and the deterioration of the dollar's role in the world's financial structure characterize these years. In chart I, the difference betweeen the unemployment and inflation behavior of 1950-1965 and of 1966-1980 is striking. It is obvious that the joint path of these variables was different in the two periods. If we recognize that the inflation of 1951 reflects the Korean War, then the path of unemployment and inflation between 1950 and 1964 can be interpreted as seeking an equilibrium, which the closely bunched "points" of 1956-64 represent. The increasing dispersion and the progression of the inflation unemployment points towards the northeast illustrate the increasing turbulence of 1965-80.

Once we appreciate that the system evolved from tranquility to turbulence, the natural question to ask about the 80's is whether the trend of increasing turbulence of the 1970's will continue and if not what will replace this turbulence. In the past the American economy had periods of turbulence--albeit shorter than the present period. These periods culminated in a financial crisis which led to a deep depression. After the crisis and deep depression a period of financial tranquility and economic progress took place. In characterizing the phases of the business cycle, Schumpeter was prone to emphasize that it was in the post-depression recovery that the fruits of the previous "boom" were harvested. Thus the fruits of the turbulent 1930's and 40's were harvested in the post-World War II era of tranquil progress. Is there a "new" period of tranquil progress ahead?

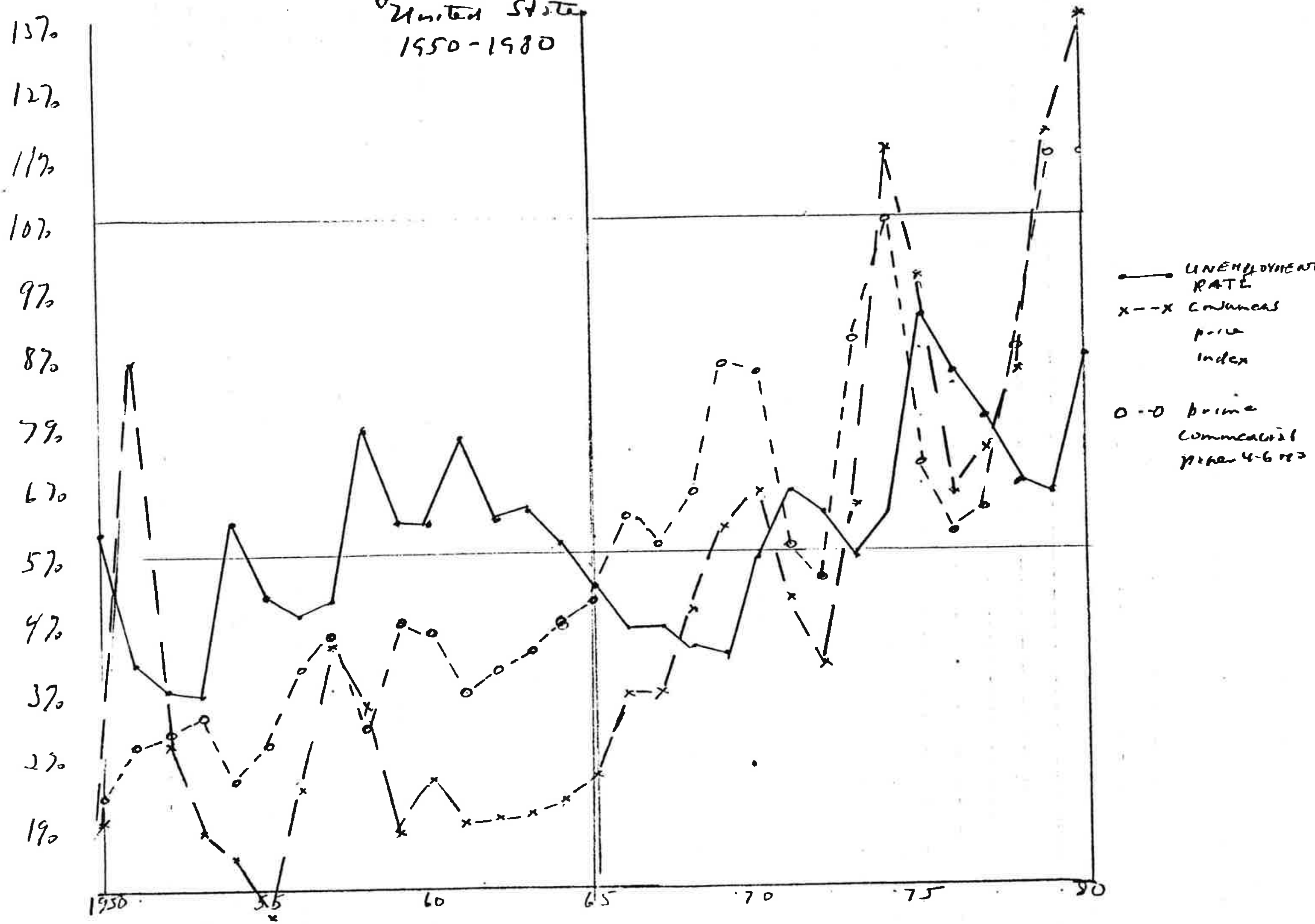
During the era of tranquility the United States protected the democratic, mainly capitalist, world in two ways. The United States provided a defense shield and the stable growing United States economy provided expanding markets and secure financial relations. Not only was there a regime of on the whole stability in exchange rates, but the United States economy provided a flow of money-capital (on both government and private account) and liquid financial assets which served as a base for the development of strong financial organizations. These strong financial organizations allowed further domestically financed expansions to take place throughout the advanced capitalist economies. During 1945-65 effective mobilizations and allocations of "money capital" took place.

During this era and beyond, up to and including the recession of 1974-75, the United States policy makers were able to operate an expansinary monetary and fiscal policy whenever the domestic situation called for such actions without much need to allow for any consequences upon the exchange value of the dollar.[3] This autonomy was largely due to the massive foreign asset position of the U.S. economy that was built up during the early post-war years. This fiscal and monetary independence of the United States, combined with an openness to imports, provided a secure and growing foundation for the economies of the rest of the capitalist world. The "miracles" in Europe and Asia in the 50's and 60's took place under the protection of this economic umbrella.

The transition from tranquility to turbulence was the result of cumulative changes in financing relations. This process began soon after World War II ended. World War II followed the Great Depression. One legacy of the Great Depression was a strong bias toward conservative finance by

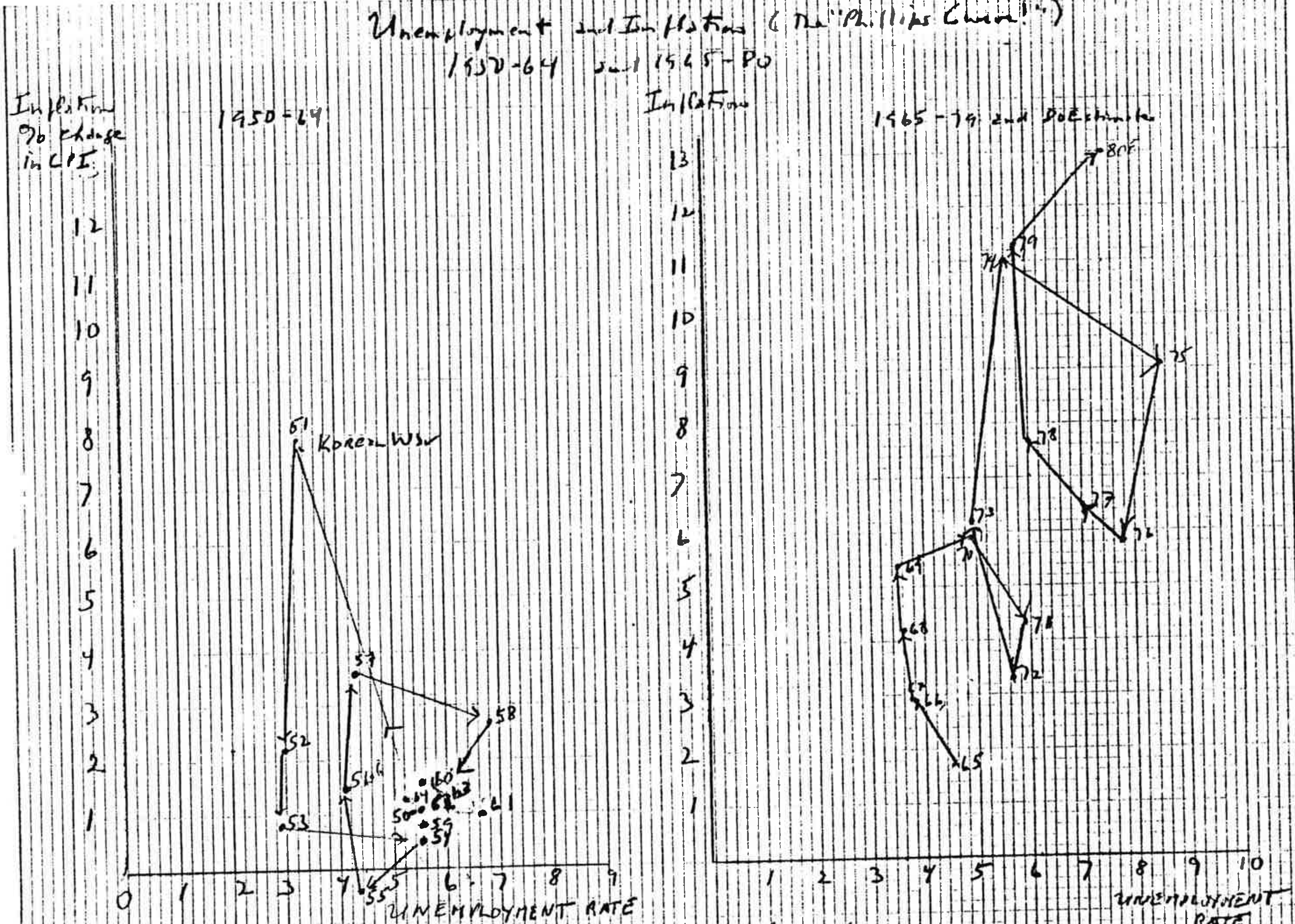
Chart II

Unemployment, Inflation and Interest Rates
United States
1950-1980



Source: Economic Report of the President January 1980

Chart I



Source Economic Report of the President, January 1980 business and banks--a bias that was enforced by government regulations. The financial legacy of World War II was an enormous government debt which enabled households, businesses, and financial institutions to satisfy their desire to be liquid. Another financial legacy of the War was that relative to income and profits households and businesses were virtually debt-free.

The enormous liquidity at the end of World War II did not lead to a burst of spending. It took well nigh twenty years of on the whole tranquil expansion before businessmen and bankers were once again heavily involved in debt financing. Once this happened, demand for finance could outrun the supply of finance so that interest rates could rise rapidly.

The transition from tranquility to turbulence that took place in the middle 60's is a result of the essential process in a capitalist economy, which is the financing of investment by bankers and businessmen followed by the recovery, with a gain, of the invested money capital. This recovery takes the form of a stream in time of gross profits (inclusive of interest payments by business).

In the Truman and Eisenhower years business was sufficiently successful so that payment commitments on financial instruments were almost always fulfilled and dividends on common shares rose rapidly. In the Kennedy-Johnson era, monetary and fiscal policies were used aggressively to promote expansion. The tax law was changed to allow a greater cash flow to business for any business pre-tax profits if business invested. The success of these policies and the prospect of increased profits led in the mid-60's to a euphoric boom. This boom had the first conglomerate and takeover wave of the post-war period as its centerpiece. As a result the growth of business debt relative to income and liquid assets, which began soon after World War II, accelerated.

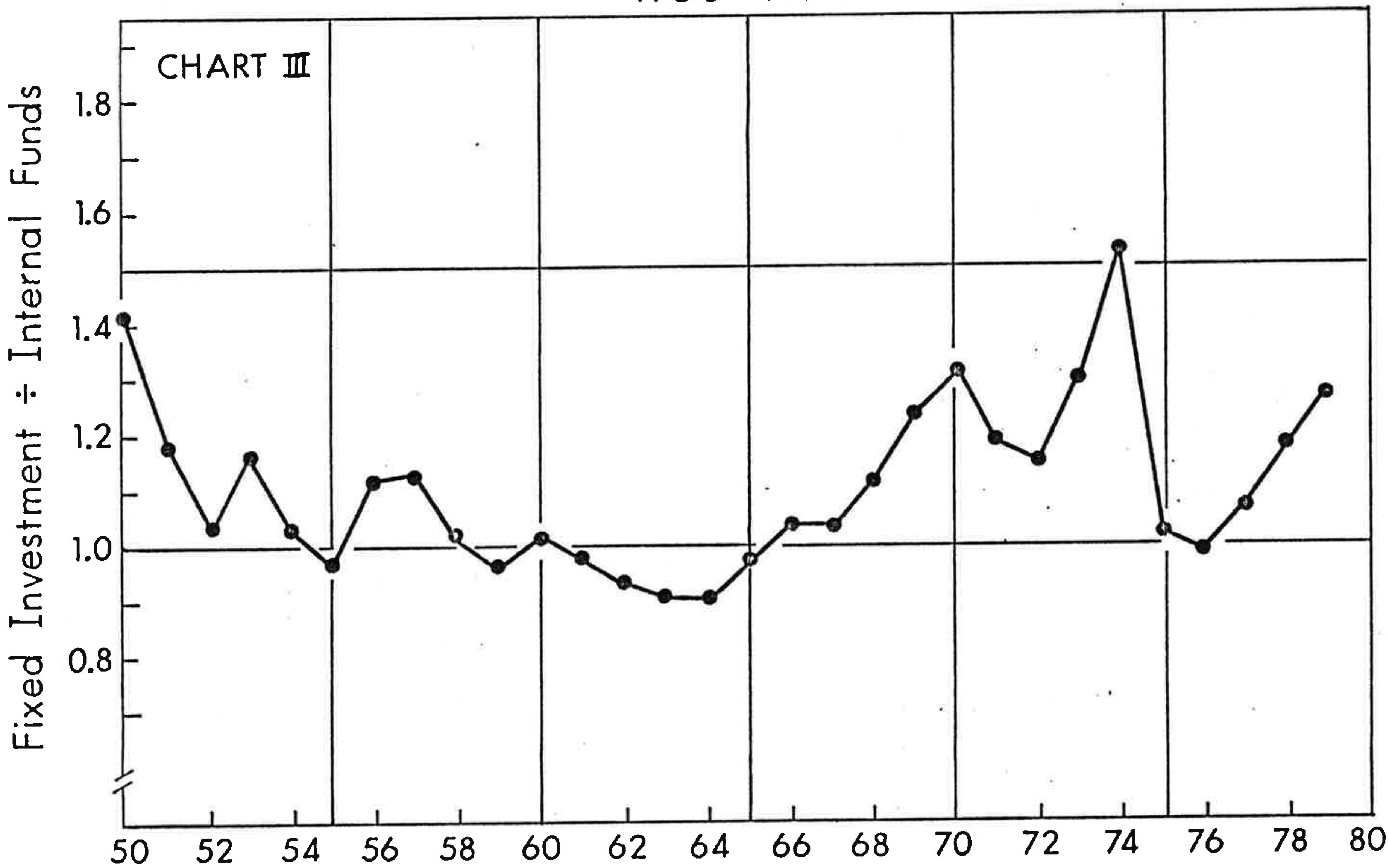
Alongside the increase in the use of borrowed funds by business (as shown in Chart III), households increased their use of debt (Chart IV). Along with the rise in business and household use of debt, commercial banks became less liquid and more heavily levered (Chart V). Payment commitments increased relative to income and along with this the need to borrow to repay debts increased. The trend of financial relations that the attached charts show is from "robustness" to "fragility." A fragile financial structure not only makes interest rates much more volatile but it also leads to periodic threats of a financial crisis.

The success of the Kennedy-Johnson expansionary policies triggered a speculative investment boom. One facet of the boom was a run up of interest rates as the demand for finance outraced the supply that was available. This was true in spite of financial innovations that led to the negotiable certificate of deposit, the greater use of commercial paper by "non-financial". firms, and the development of the Eurodollar market, to cite several of the most visible changes.

The rise in interest rates in 1965/66 brought about a wave of "disintermediation" which forced some banks and other financial institutions to try to acquire cash by selling municipal bonds. This led to a sharp drop in the prices of municipal bonds. The Federal Reserve intervened (by opening the discount window) to constrain and control the losses of banks.

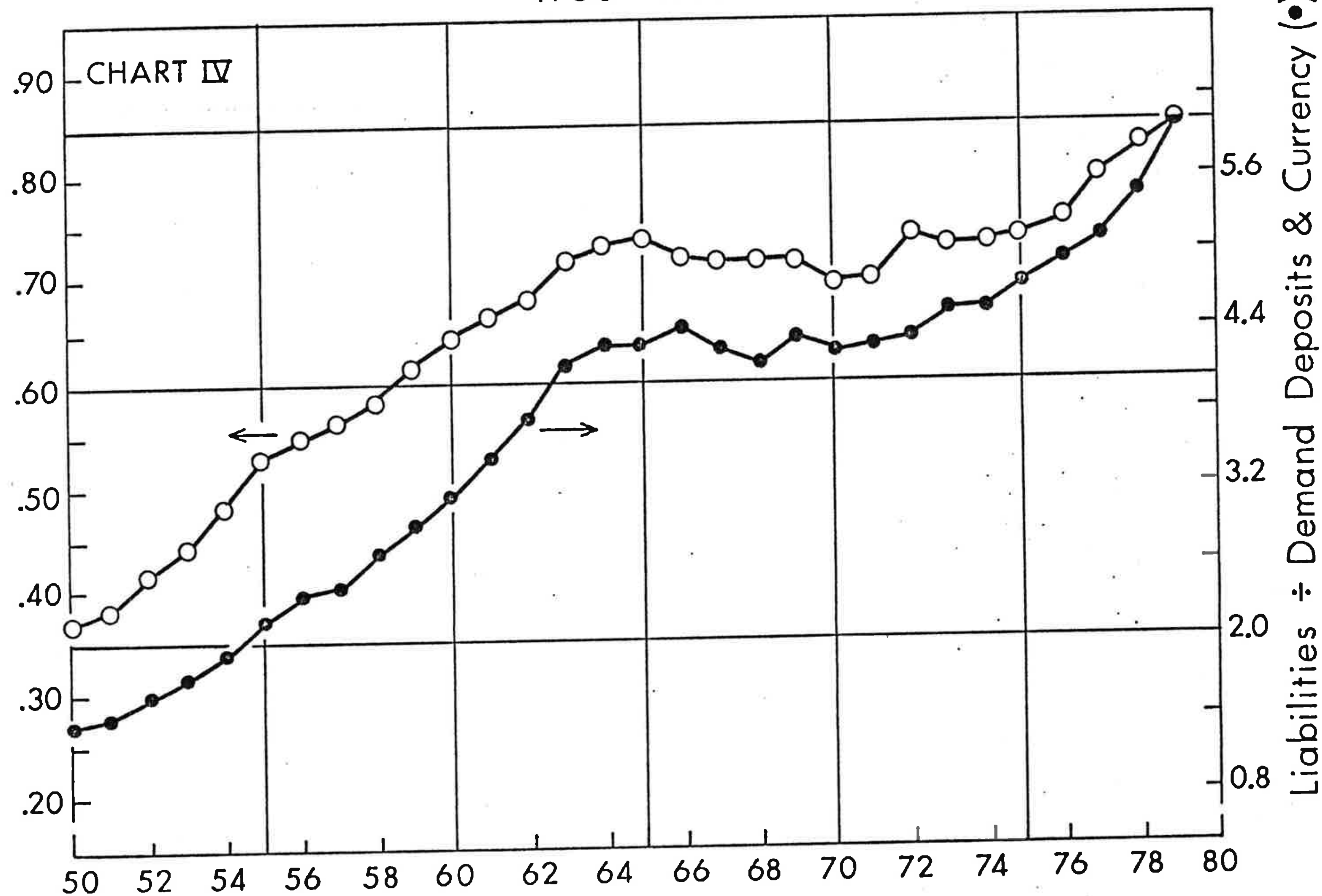
Because of the increased expenditures due to Vietnam the effect of this crunch of 1966 upon income and unemployment was but a slowdown in growth, not a recession. However, this crunch of '66 set a pattern that was repeated in 1970, 1975 and 1980. In this pattern a crisis, that threatens the viability (solvency or liquidity) of some major business or financial industry emerges after interest rates rise to unprecedented heights in response to a Federal Reserve fight against inflation. A result of this is that large as well as

Non Financial Corporations
Fixed Investment ÷ Internal Funds
1950 - 1979



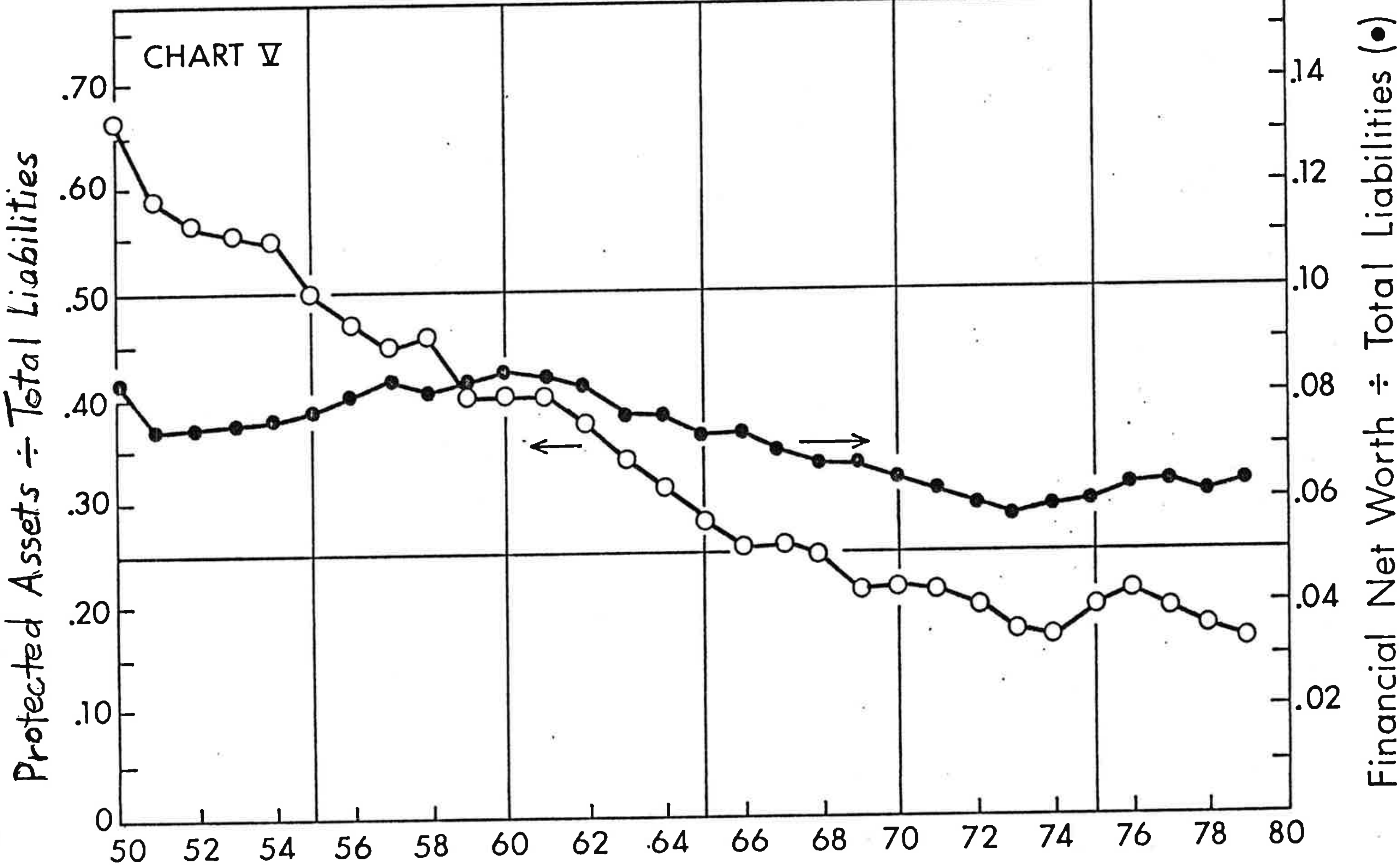
Source: Board of Governors Federal Reserve System - Flow of Funds Accounts

Households
Liabilities Divided by
1. Disposable Personal Income
2. Demand Deposits & Currency
1950 - 1979



Source: Board of Governors, Federal Reserve System – Flow of Funds Accounts

Commercial Banking
Financial Net Worth and Protected Assets
as Ratio to Total Liabilities
1950 - 1979



Source: Board of Governors Federal Reserve System – Flow of Funds Accounts small institutions fail (Penn-Central and Franklin National) or the Federal Reserve or the Treasury intervenes to refinance organizations which threaten to fail (Chrysler Finance in 1970, New York City in 1975 and Bache and Company in 1980) before actual failure occurs.

The sequence through the past decade is clear. Inflation is diagnosed as the dominant policy problem and the Federal Reserve resolutely sets out to fight inflation by trying to restrict the availability of credit or constrain the growth of what is taken to be money. Because of innovations, the growth of financing continues after the Federal Reserve takes this constraining posture. The combination of investment activity, innovative finance by business and financial institutions, and Federal Reserve constraint sets off a "race" between the effect of credit restraint in reducing demand and the effect of financial market interactions (in raising interest rates, lowering market values of assets and restricting available packages of financing) in compromising the financial viability (liquidity and solvency) of businesses and financial institutions. If the reducing demand "horse" wins, which is what both monetarist and orthodox Keynesian theory says must happen, then inflation will abate at some minor cost in income and employment. If the financial viability "horse" wins then the Federal Reserve must contemplate the possibility that an interactive debt deflation is starting.

Once significant sets of businesses and financial institutions or even of isolated large units are threatened with failure the Federal Reserve must decide whether to stand aside and let the market resolve the financial disruption or to intervene as a lender-of-last-resort to directly or indirectly refinance or bail out the organizations whose liquidity or solvency has been compromised. In 1969-70, 1974/5 and 1979/80 the race between the "tapering off" of demand and a break in the viability of financial relations was won by a break in the viability of financing relations. In each case the Federal Reserve quickly donned its lender-of-last-resort hat and helped bail out the institutions and markets that were at hazard: the commercial loan market in 1970, the Eurodollar market in 1974/75 and the markets which finance commodity transactions in 1980. In each case the "crisis" became evident--the failure of the Penn Central, the bankruptcy of Franklin National, the troubles of the real estate investment trust, and the curious Bache/Hunt episode in silver were public events--so that a pause or a recession followed.

During and after the recession the Federal government runs enormous deficits--$100 billion dollar annual rates in 1975 II, comparable annualized rates in 1980 III and IV. These deficits sustain and increase business profits in the broadest sense of after-tax gross cash flows. As a result of the deficits profits and employment are sustained, so that the payment commitments on business debts are fulfilled and financial institutions acquire significant positions in government debts. Even as profits and income are sustained, balance sheets are improved. The government deficit and the intervention by the Federal Reserve sets the stage for the quick resumption of inflation.

The Federal Reserve and Treasury interventions in March and April of '80, in dealing with the problems of The First of Pennsylvania (a big bank), Chrysler and the silver speculation of the Hunts et al, can be interpreted as a preemptive strike that aborted an incipient crisis. As a result the decline in income of 1980 barely passes the filter that defines a recession and there was but a slight pause in the course of inflation and interest rates. Hence the current talk of a "double dip" recession, in which a fall in income and a rise in unemployment takes place in the near future. If our scenario of a race between a decline in inflationary pressures through demand constraint and a crisis which threatens the financial viability of significant institutions is valid, then the second dip will take place along with or after an incipient financial crises that will once again pose the "to intervene or not to intervene" question for the Federal Reserve.

We have set the stage for an argument about the course of the American economy (and its interactions with the world economy) in the 1980's. Over the late sixties and the seventies the American economy was increasingly cyclical, in that a four to five year cycle ruled the roost. These cycles had on the whole mild recessions. In terms of inflation, unemployment rates and interest rates these cycles resulted in a trend of things getting worse.

The cycles of the seventies rested on three pillars: a fragile financial structure, Federal Reserve intervention as a lender-of-last-resort and big government that ran a massive deficit whenever a recession took place. Federal Reserve intervention and the massive government deficits contained the thrust towards a deep depression that financial disruption within a fragile financial structure triggered. If either Federal Reserve intervention or the massive government deficit is missing then the recession will not be mild and the recovery will not be quick.

We will soon have a new political and economic leadership in the United States. (As this is being written the exact coloration of the economic policy leadership of the Reagan administration is not clear.) Of the four financial disruptions since World War II that led to Federal Reserve action two occurred in Democratic Administrations (1966 and 1980) and two in Republican (1970 and 1975). Perhaps the Republican administrations were a trifle slower in reacting as a deficit generator and they may have sustained monetary constraint a bit longer than the Democrats. However, in all four cases the reactions were prompt and forceful, so that a debt deflation and a deep depression did not occur.

However, the interventions by the Federal Reserve as a lender-of-last-resort was not born of any understanding of why the actions were necessary but rather mainly relflected a fear of an unknown consequence. Thus it is possible that the Federal Reserve and Treasury will not intervene in the next incipient financial crisis as forcefully as in the four episodes since 1966 and that the government will not react to rising employment by deliberately increasing the government deficit. If such a hands-off policy is adopted, then an interactive cumulative process will gain momentum which may start the economy on the road to a serious depression.

As long as government is "big" a serious decline in income leads to an enormous deficit. This deficit sustains both profits and prices. Thus a free-falling process, such as led to the Great Depression in the 1930's, cannot occur. However, something substantially larger and deeper than the 1974/75 decline can easily take place if the Federal Reserve stands aside as a financial crisis gains momentum.

The run up in interest rates in November 1980 together with the enormous short-term debt burden of business, which was not reduced by any appreciable amount in the recession of 1980, indicates that an early testing of the Federal Reserve's willingness to act as a lender-of-last-resort in the new political environment will take place.

A fragile financial structure is a necessary condition for the cyclical pattern of the last fifteen years to rule. Thus one way to improve the performance of the economy is to replace the fragile financial structure with a robust structure. A robust structure will make tranquil progress, such as ruled in the fifties and early sixties, possible.

As was suggested earlier, a transition from financial fragility to robustness was achieved during the serious depression of history. The extremely robust financial structure of the fifties resulted from the wartime deficits that followed the Great Depression. Is it possible to achieve a robust structure without the trauma of a serious recession or the deficits that comes with war?

The Reagan administration comes to power as a conservative reform administration. Certainly the election is being interpreted as a "mandate" for structural reforms. One main thrust from reformers associated with the new adminsitration is that the existing tax, regulation and income maintenance systems restrict supply by reducing incentives or imposing costs. It is true that every tax, regulation and transfer payment reduces incentives and imposes costs. Thus there will be a supply side effect from decreasing the burden of such measures. The question is how much, and furthermore, will such reforms have side effects that will cause troubles?

In my judgement the empirical evidence makes the larger claims of the supply side "effects" questionable; income will not rise by so much that a thirty percent reduction in tax rates will lead to a more than thirty percent rise in real income so that real tax revenues rise. Furthermore measures advocated by supply side economists are largely tax law changes that increase business cash flow for any level of aggregate income; i.e., increase profits per unit of output.

The experience with prior tax law changes that increase business cash flows is that while the debt income ratio is initially improved, debt expansion follows so that the payment commitment/income ratio soon reaches and exceeds prior levels. Furthermore the success of business and bankers in meeeting financial commitments fosters the development of new types of instruments to finance asset acquisition and investment.

The financial instability concerns that I have raised are not included in the bill of particulars against the present structure that gives rise to the incoming administration's agenda for reform. The financial aspects of the reform agenda consists of two slogans: money supply and deregulation. As Henry Kaufman recently pointed out, the monetarists' concept of money has little if anything to do with contemporary corporate payment practices and the deregulation of financial organizations is simultaneously inflationary and destabilizing.[4] Thus apt reforms to bring the disruptive cycle to a halt are not to be expected from this administration. Are there reforms that might succeed in breaking the cycle by removing the financial basis for the cycle?

In order to return the system to financial robustness it is necessary to first reduce and then constrain the use of debt, especially short-term debt, by business, banks, households and financial institutions. The inflation of the seventies has led to both an increased reliance on debt and a shortening of the maturity of debt. Not only is business debt being shortened but the fully amortized long-term fixed interest rate home mortgage that came on stream in the United States in the mid-1930's is rapidly disappearing. Thus the near-term payments due in debts are increasing. Many debt structures can be validated only if inflation continues.

Any program of financial reform needs to recognize that the giant multidimensional corporations of the United States (and the multinationals as well) are increasingly taking on the appearance and the functions of banks. The top management of giant corporations are mainly concerned with the raising and deployment of money-capital and the various organizations under their control are sources and outlets for this money capital. Money capital is raised not just by cash flows from operations but also by access to a wide variety of financing markets; the cash flows from operations in a modern giant corporation are mainly viewed as funds that validate debt.

Thus reforms that look toward increasing the financial robustness of the American economy will need to look towards strictly limiting the liability structures of business and financial institutions. Instead of easing regulation there is a need to increase regulation so that financial structures become less prone to instability and therefore less dependent upon Federal Reserve interventions and government deficits.

Of particular importance in any structure of reform would be changes in the tax laws that encourage equity financing and the ownership of equities. Perhaps on that score we can expect some desirable changes from a Reagan administration.

Thus we start 1981 with a history of financial instability over the 1970's and with a papered-over financial trauma in our recent past. We should expect a financial crunch or crisis sometime in 1981, most likely by spring. With a spectre of Hoover no longer haunting Republicans, I see a fair chance that deliberate increases in deficits and lender-of-last-resort interventions will be delayed. Thus the second dip should be more severe than that of 1980.

The makers of economic policy in the United States do not have the liberty of setting policy in the expectation that the hoped-for favorable outcome will take place in four or five years. Another election for Congress will occur in just two years. If a crisis develops in the next several months then, with a pause, the new administration will likely turn to standard monetary and fiscal expansion. If this happens the seeds will be planted for a subsequent inflation at rates that exceed recent rates.

The hands of the conservative reformers of the Reagan administration will be constrained because unemployment and inflation are likely to be in a poor state a year from now, even as the election of '82 begins to loom large in the

Congress. I see another round of the dismal cycles of the past fifteen years albeit with a greater unemployment rate at the trough of the cycle than in the recessions of 1975 and '80 and with a recovery that is not satisfactory even though inflation rates are high. The alternative to this scenario is a serious and prolonged recession beginning in 1981--but American politics argue against any Thatcherian resolve to muddle through.

If we are to do better in the United States, economic policy needs to be guided by an economic theory that is more perceptive about the interrelations within capitalism of finance and system behavior than is true of either the monetarism or the fiscal Keynesianism that guides policy. Until reforms based upon such alternative perceptions are made, I see two dismal alternatives before the United States: one is more of the same cycles, the other is a transition to a more robust financial structure by means of a deep and lasting depression. Either way the rest of the world should expect to live within the context of an unstable United States economy for another "cycle" of four or five years. Perhaps after this round, we can begin to seriously consider the financial reconstruction of the United States. As things stand the reforms on the new administration's agenda are irrelevant to the serious problems of the economy.

FOOTNOTES

[1]John Maynard Keynes, "The General Theory of Employment," Quarterly Journal of Economics 51 (February, 1937), 209-23.

[2]The distinction between uncertainty and risk follows F.H. Knight. See F.H. Knight, Risk, Uncertainty and Profit.

[3]Hyman P. Minsky, "Financial Interrelations, the Balance of Payments and the Dollar Crisis," in J.D. Aronson, ed., Debt and Less Developed Countries, Westview Press/Boulder, 1979.

[4]Henry Kaufman, Financial Challenges Confronting the New Administration, Solomon Brothers, New York, November 1980.

Unemployment, Inflation and Interest Rates

United States
1950-1980

	Unemployment[1]	Inflation[2]	Interest Rates[3]
1950..................	5.3	1.0	1.45
1951..................	3.3	7.9	2.16
1952..................	3.0	2.2	2.33
1953..................	2.9	.8	2.52
1954..................	5.5	.5	1.58
1955..................	4.4	.4	2.18
1956..................	4.1	1.5	3.31
1957..................	4.3	3.6	3.81
1958..................	6.8	2.7	2.46
1959..................	5.5	.8	3.97
1960..................	5.5	1.6	3.85
1961..................	6.7	1.0	2.97
1962..................	5.5	1.1	3/26
1963..................	5.7	1.2	3.55
1964..................	5.2	1.3	3.97
1965..................	4.5	1.7	4.38
1966..................	3.8	2.9	5.55
1967..................	3.8	2.9	5.10
1968..................	3.6	4.2	5.90
1969..................	3.5	5.4	7.83
1970..................	4.9	5.9	7.72
1971..................	5.9	4.3	5.11
1972..................	5.6	3.3	4.69
1973..................	4.9	6.2	8.15
1974..................	5.6	11.0	9.87
1975..................	8.5	9.1	6.33
1976..................	7.7	5.8	5.35
1977..................	7.0	6.5	5.60
1978..................	6.0	7.7	7.99
1979..................	5.8	11.3	10.91
1980 Estimate.........	7.4	13.0	

[1]Unemployment rates in Percent of Civilian Labor Force.
[2]Inflation changes in Consumer Price Index.
[3]Interest rates on Prime Commercial Paper 4-6 months.

Source: Economic Report of the President, January 1980, except for 1980 estimate.