6-7-1984

What "Continental Illinois" is Telling Us

Hyman P. Minsky Ph.D.

June 7, 1984

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Last month the Continental Illinois Bank was saved from overt bankruptcy by massive support from the Federal Reserve, FDIC and a corsortium of giant banks. Continental Illinois was but the latest in a string of contained financial crises that stretch back to the credit crunch of 1966. For the first twenty years after World War II no financial crisis occurred that forced the Federal Reserve to intervene as a lender of last resort. In 1966, 1969/70, 1974/75, 1979, 1981/82 and 1984 the Federal Reserve put on its lender of last resort hat to prevent a financial crisis from fully developing. It did this because "it" believed that without intervention the door would be open to a serious depression.

Each time a fully realized crisis - such as 1929/33 - or a contained crisis - such as those since 1966 - occurs it is possible to explain what happened by listing mistakes or citing the incompetence of officials. The Continental Illinois failure is being explained by its involvement with Penn-Square, the unit banking laws of Illinois, or its dividend policy. However, as financial crises have been a regular feature of the American economy it is rational to suspect that what we experience are normal events which reflect basic characteristics of our type of economic system.

Our economy is a capitalist economy with a complex and evolving financial structure. The ownership and creation of capital depends upon borrowing and lending that are based upon margins of safety. These margins take the form of liquid asset holdings, asset values and, most important, an excess of anticipated cash flows over payment commitments due to debts. Each day, for borrowers and lenders alike, is a moment in a financing program that stretches over time. These financing "plans" include borrowings to carry out committed projects and to refinance maturing debts. Both borrowers and lenders are dependent upon the economy functioning so as to generate the requisite cash flows and financial markets functioning so that debt instruments can be readily negotiated or issued.

When the economy and the financial system function well, the provisions for unfavorable circumstances in the margins of safety prove to be excessive. There are opportunities to earn profits by relaxing the margins of safety and use the now excess liquidity or borrowing capacity to finance increased activity. As this financing capacity is put to use a closer articulation between payment commitments and expected cash receipts develops. As a result speculative liability structures, that require debts to be issued so that debts can be paid, and Ponzi liability structures, that require the interest that is due to be paid by increasing debt, develop.

As speculative and Ponzi financing arrangements became more important, higher interest rates or normal declines in income adversely affect the ability of more and more units to fulfill their commitments. Furthermore speculative and Ponzi units are vulnerable to disruptions in financial markets even as financial markets are increasingly disrupted by changing interest rate patterns. Whenever speculative and Ponzi finance are important and investment projects have long gestation periods rising interest rates lead to an increase, not a decrease, in the demand for finance relative to the supply. Rising interest rates set up market reactions that make for further increases in interest rates.

Speculative and Ponzi finance became significant, after a hiatus due to the aftermath of the Great Depression and a great war in the mid-1960's. Since then our financial markets and demand determining interactions have operated so that rising interest rates slow down the economy not by reducing demand but by forcing units of significant size into refinancing crises. Monetary constraint operates by forcing some significant units into, or to the verge of, bankruptcy. But if unchecked, such induced bankruptcies will trigger an interactive process that leads towards a great depression. The Federal Reserve, in an effort to constrain inflation forces the economy to the brink of a crisis, and then feels forced to rush in, abandon its attempt to constrain inflation, and act as a lender of last resort.

Of course Continental Illinois was guilty of poor banking practices. But more important, Continental Illinois was the weak link in a system that was under pressure. If Continental Illinois had not broken, the build up of speculative and Ponzi finance would have continued until some new weakest link broke. Continental Illinois is not in any significant sense the cause of the financial malaise that now affects our economy, the malaise reflects structural characteristics.

In the aftermath of the virtual bankruptcy of Continental Illinois the Federal Reserve is increasing the reserves of the banking system. Reserve availability and a massive government deficit are a recipe for inflation. The financial structure is sending a message: the choice before us is to take a deep depression, accept a serious inflation or constrain financing techniques. None of these are really palatable.