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Depression, 1990's Style

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Six months ago, as winter was approaching, fears were widespread that several of the principal money market banks were on the verge of bankruptcy: many believed that a collapse of the financial structure, which would transform the recession into a depression, was about to happen. About sixty days ago, as spring began, a muted optimism became the order of the day. Indicators of an improvement in the economy, such as a slight increase in retail sales, ~~or~~ a slight decline in new applicants for unemployment insurance and were greeted in the financial press and by spokepersons for the government as a sign that the recession was approaching its end. Now, as summer nears, it is being accepted that the optimism of the spring was unwarranted, that the recession may deepen and last through 1991 and that the recovery, when it occurs, will be weak.

The current recession is much more of an integrated financial, demand, distribution and production phenomena than earlier post world war 2 recessions. Neither orthodox monetarists, whose views guided policy during the ascendency of Reagan-Thatcher, nor conventional Keynesians, whose views guided policy during the prior reign of liberals and wets, analyze the economy as an integrated financial, distribution and production system. The theories that guided economic policy in the past forty-five years do not have the explanatory power they once had: they do not now lead to policy interventions that can cope with emerging crises and guide the economy to sustained and broad prosperity. The malaise that is evident in society is the result, in part, of a loss of faith in the ability of the generally accepted economic analysis, what is called "mainstream economics", to provide prescriptions for the shortcomings of the economy.

The international distribution of economic power is different than it was earlier in the post world war 2 era. The economic dominance and financial autonomy of the United States has been much diminished. Internationally, much that is good took place during the time the United States was dominant: in particular opportunities were opened nations to develop.

A strong case can be made for the proposition that the United States used it's economic power in a responsible way after World War 2. It is not often expressed, but it is broadly accepted, that Japan and Germany, the economic and financial powerhouses of the 1990's, are not strong in either altruism or responsibility. They are not to be expected to voluntarily take measures that would assure that global aggregate demand is sustained: they will not deliberately expand their economies, risking inflation and a loss of export markets, so that the spilling over of demand fosters international economic expansion. During the past 45 years the United States put its economic dominance at risk and provided an economic steering wheel for the world economy. The cumulative effect of this behavior eroded the economic dominance of the United States. One result is that the world now is now without an economic steering wheel.

A great economic contraction, such as occurred between 1929 and 1933, is not a quick, large and simultaneous fall in all of the measures that are used to judge the performance of an economy. A serious contraction is a process that often moves slowly: sharp declines are followed by apparent recoveries that are followed by a slow sinking and stagnation that leads into a crisis and a sharp drop in the economy. A succession of financial crises, spread out over a number of years, takes place, each one having a negative impact on aggregate demand and aggregate profits. Interventions that aim to contain a particular financial trauma seem to be successful, only to have financial difficulties appear in some other sector or set of institutions. False recoveries and short lived resolutions of difficulties are common during a contraction that leads to a full blown depression. Apparent recoveries and financial restructurings provide evidence that is interpreted to mean that "prosperity is just around the corner". Short lived bursts of optimism that are not validated by sustained improvements in business activity characterize the path to a deep depression.

In the great collapse of the American economy some forty months elapsed between the triggering event, the October 1929 stock market crash, and the breakdown of the banking system and the closing of the economy, in February 1932 . In the modern world, government is a much larger part of the economy than it was 60 years ago and central bank interventions are not constrained, as in the 1929-33 period, by rules derived from the gold standard. As a result of these differences a process that would result in a debacle as complete as that of 1933 is unlikely to occur. Nevertheless a protracted deterioration of the economy, over a period that is substantially longer than 40 months, cannot be ruled out. A 1990's style depression is likely to have a longer contraction phase and the overall decline is likely to be smaller than that of the Great Depression. Furthermore, just as in the Great Depression, the end of a 1990's style depression contraction phase can not be expected to lead to a vigorous and complete recovery.

Since the stock market crash of 1987 many aspect of the American economy have behaved as if a long economic contraction was under way. The early stages of this contraction were masked by a highly speculative expansion in which income from the rapidly growing "financial services industry" and the consumption financed by such income contaminated both data and perceptions. Developments in Latin America, Europe and Asia can also be interpreted to indicate that a long global contraction is under way.

If we use the global stock market crash of October 1987 as the triggering event for the long contraction, the economy has been in a decline for 43 months. Indications are that further financial difficulties, which will impact upon investment, consumption and government spending, are in the wings ready to go on stage. This implies that further declines will take place, so that the contraction trend will continue for many more months.

One reason for the improved atmosphere this spring was that the failure of the 22 billion dollar Bank of New England, which took place last January, was resolved and no new crisis in banking quickly followed. In the resolution the Federal Deposit Insurance Corporation exchanged cash for between $6 to $8 billions of the bank's non-performing assets, so that a cash rich clean bank rose out of the ashes. A combination of the Kohlberg, Kravis Roberts & Co, the leveraged buy out firm whose principal players were featured, like a babble of movie stars, in the best seller Barbarians at the Gates, and the Fleet Bank of Providence Rhode Island have taken over the clean bank.

The clean bank has only performing assets and a cash hoard that replaces the non performing assets that triggered the bankruptcy. The clean bank will not have the costs associated with administering a large portfolio of non-performing loans. The combination of cash in hand and an absence of non-performing assets will give it a competitive advantage in not only the New England market but also nationally and internationally. This will force the earnings of other, already weakened, banks to fall. Rumors are rife that The Shawmut Bank, a large competing bank, whose headquarters are in Hartford Connecticut, is in trouble.

Financial crises and deep depressions are outcomes of processes internal to the economy. A characteristic that is evident in the long history of financial crises and deep depressions is evident once again: the apparent resolution of one crisis, in this case that of the Bank of New England, leads to another crisis, in this case that of the Shawmut Bank. Such destabilizing interactions are analogous to those that lead to the explosions that characterize epidemics and other chaotic phenomena.

In April insurance regulators in California seized control of a unit of First Executive Life, a major seller of annuities, because it was financially impaired. Pensioners who hold First Executive Life Annuities now will be fortunate if they receive 70% of what they were receiving several months ago. In May the California insurance regulators seized control of First Capital Life Insurance Company, deeming it to be in hazardous financial conditions. Both the First Executive and the First Capital units were in trouble because of their investments in junk bonds and real estate.

Bond ratings create lists of securities that are of investment grade and therefor are eligible for the portfolio's of "fiduciaries", i.e. individuals and organizations which act in the interests of their clients rather than in their own interests. Junk bonds are below investment grade and therefor in theory are not eligible for the portfolios of fiduciaries.

In the normal course of business some firms which issue investment grade bonds make losses, so that the quality of their bonds deteriorate. Before the modern era of big government capitalism and the stabilization of aggregate profits by government contracyclical deficits, aggregate business profits normally dropped in a business cycle recession. When this happened the cash flows and equity margins of safety of many borrowers that had made their liabilities investment grade decreased. In this process many bond issues became less than investment grade, became junk.

The quality of many such issues, which were junk because of the impact of recessions, recovered as the economy recovered. As a result, once a recession was contained and the economy recovered, the total earnings on a diversified portfolio of recession created junk bonds was greater than the earnings on a diversified portfolio of bonds that remained investment grade throughout the recession.

In the 1980's a proposition that was valid for portfolios of recession created junk bonds was extended, by portfolio theorists and brokerage houses such as Drexel Burnham, to become an investment strategy for managers of portfolios. The strategy, "invest in portfolios of bonds that are created as junk", was defended by the assertion that a diversified portfolio of bonds which do not qualify for investment grade will earn more than a diversified portfolio of investment grade bonds.

Because of a combination of the tax laws which exempt interest from the base for calculating corporate income taxes and the optimistic views that an era of permanent prosperity had been ushered in with the Reagan "reforms", a proliferation of high interest rate, thin margin of safety (in value and in cash flows) issues that were "born as junk" took place in the 1980's.

Many portfolio managers chose to ignore the traditional rules which limited the individual assets a fiduciary could and should have in its portfolio to investment grade debts and acquired portfolios of junk bond. Each issue in this portfolio was not eligible for holding by fiduciaries but, it was argued, the portfolio as a whole was investment grade. In the current recession, many issues of junk at birth bonds have become non performing. As a result portfolios of such bonds have behaved less well than portfolios of bonds, each of which was eligible for the portfolios of fiduciaries. One set of financial intermediaries after another has been adversely impacted by non-performing bonds.

The Reagan era saw a decline in Federal government financing of social programs and a rise in state and local spending on these same programs: in the prosperous eighties the rise in state and local revenues made such spending affordable. The recession has led to a fall in state and local revenues even as the recession has led to a rise in state and local expenses. In state after state a budget crisis became the order of the day in 1991.

States and local governments often have no option but to prepare a balanced budget: the need to maintain their bond ratings depend upon and enforce fiscal prudence. Forced closing of schools and the cutting of programs that provide amenities are now nation wide phenomena. The great state supported research Universities which are one of the glories of the United States, are now retrenching.

A combination of raising taxes and cutting spending by State and Local governments is evident from coast to coast: it is not only a phenomena of New York, where the budget is $7 billion in deficit but also of California, where the deficit has ballooned to $14 billions. It is estimated that the total expected deficits of state government for fiscal 1992, the year that state governments are drawing budgets up for now, is in excess of 50 billion dollars. A combination of cuts in state spending and increases in taxes that adds up to 50 billions will start hitting the national and global economies in the second half of 1991 and 1992.

The fiscal problems of the States and localities will give an already tottering economy a downward push. The recession cannot but be adversely affected by these problems. The state and local fiscal crisis will lead to a further deterioration in the portfolios of banks, savings banks, insurance companies and pension funds. The rise in real estate taxes, a major component of state and local taxes, will depress real estate values. This will depress the portfolios of the intermediaries that hold either real estate related debts or equity (ownership) interests in commercial real estate.

The full impact of the financing of too much commercial construction during the late 1980's has not been felt in the rental yield of existing commercial (office) buildings. Once this occurs another blow will be delivered to portfolios that are invested in real estate and mortgages.

Even as signs proliferate that the system is moving along a trajectory that can end with a depression, policy assumes that the economy has self righting properties that are adequate to contain and turn around this recession. A "Pollyanna" is one who only sees favorable possibilities: the contrast to a Pollyanna may well be a hard nosed realist.

Conventional economics does not allow for a disaster, such as a great depression, to be the normal outcome of economic processes. The widespread financial fragility, the obvious increasing weakness in commercial construction, the shift of economic power to countries that pursue their own narrow self interest and the fiscal compromising of the American government as a result of the budget policies of the past decade, all indicate that the potential for a serious recession, even unto a depression, is greater now than ever before in the post war world. In this potentially serious situation the Bush administration takes a Pollyanna attitude towards the economy seemingly believing, that whatever is happening is all for the best. The Republicans look at an 11% unemployment rate as an 89% employment rate.

The Democratic party is not seizing the issue. They are cowering in fear of the demagoguery that the administration has been shown to be capable of unleashing. The potential for this recession being prolonged and deepened so that it becomes a modern day depression, is increasing, for the administration lives by the faith that a modern version of the great depression cannot happen and the opposition is both devoid of understanding and unwilling to confront the "Victor in the Desert".