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Approaching 1984: Recovery In the Context of a Fragile Financial Structure

Hyman P. Minsky Ph.D.

THE MAKING OF 1984:
A Look at the Policies and Issues

Our recent institutional conference, "The Making of 1984: A Look at the Policies and Issues," held in New York City on October 5-6, 1983, previewed issues, candidates, and policies in the coming election year. We have summarized each speaker's message on the following pages, although we do not represent that we have captured precisely or entirely all that they thought was important. The summaries were made from notes of the speakers' presentations and purport to capture the general sense rather than the precise phrasing of each viewpoint.

The overall message seems clear in both the political commentary and in the economic issues:

☐ The nation's politics are turning increasingly to foreign issues in the coming election year, not by choice but by circumstance.

☐ The management of Third World debtor nations could emerge as a major issue in U.S. foreign policy any time from here on.

☐ The predicament of the Third World debtors is in good measure attributable to policy mistakes in the United States in recent years. Remedies involve the buildup of substantial U.S. trade and current-account deficits.

☐ In retrospect, the 1980 Presidential contest was not a critical election — i.e., a one-in-a-generation galvanic mobilization of the uncommitted.

☐ President Reagan has clear problems with groups who supported him in 1980, or who opposed him less vigorously than now. Messrs. Mondale and Glenn are the front runners in the Democratic party, although the White House is more concerned with Glenn.

☐ The 1984 electoral contest will probably be characterized by strong conflict between competitive candidates, as contrasted with the search for conciliation in 1980.

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CONTENTS

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APPROACHING 1984:
Recovery in the Context of a Fragile Financial Structure

Hyman P. Minsky *is Professor of Economics at Washington University, St. Louis, a position he has held since 1965. Previously he held associate professorships at the University of California, Berkeley, and at Brown University. Professor Minsky is well known for his articulate writings on the instability of financial processes in modern capitalism and on the risks of debt deflation in today's institutional environment.*

Fragility is the ability to absorb or contain shocks or change. Our decentralized market economy has proved to be resilient and adaptive. What contained the thrust to recession or even depression in 1982 and turned the economy around?

Normal functioning requires that financial contracts be fulfilled. For business organizations the most important variable in fulfilling contracts is gross profits after taxes, or the cash flow available to validate debt. Internationally, debtors must first earn profits in local currencies, then convert these profits into dollars. The basic source of cash flows internationally is equivalent to the trade deficit of the United States. Thus, the United States must run a deficit on trade equal to interest payment obligations on dollar-denominated world debt. We are in the ballpark in terms of the aggregate trade deficit that we need. As long as the U.S. government runs a big deficit, and as long as the government deficit is contracyclical, dollar profits will be sustained. Big government makes the collapse of the cash flows of business virtually impossible, which is one of the reasons why we've been able to absorb the financial shocks of the past 15 years without having a cumulative debt deflation.

No matter what happens on the offshore debts of major American banks, the dollar liabilities of the giant banks will be met.

Whereas Paul Volcker gives lip service to fighting inflation or creating full employment, he is concerned with the viability of the world financial structure and is committed to avoid a 1929–33-type collapse through lender-of-last-resort operations. Volcker's Federal Reserve Board will not stand aside and allow a U.S. national bank to fold. But lender-of-last-resort operations are not a free ride. The repercussions aren't immediate. In fact, the gestation can be lengthy. In turn, our economy lurches from one type of unstable situation to its exact opposite. Thus, from 1979 to 1982 we had both a run from the dollar and a run to the dollar. This gives authorities a narrow corridor in which to work. In fact, what's been happening is something like the gold standard rules of the game, where domestic monetary policy loses its freedom of action and is shaped by what's good for the exchange rate.

Since 1967, we've had periodic need to intervene by the Federal Reserve in order to protect the continued normal functioning of the financial system.

For the first 20 years after World War II, the business cycles were mild and basically nondisruptive. Since 1967 the Fed has had to intervene periodically to protect the normal functioning of the financial system. Fear of cumulative failures has been an important influence on central bank action. The fundamental cause in this change has been the increased volume of private indebtedness and the shortening of the indebtedness. Gross capital flows are affected by the business cycle, so that in periods of rising interest rates, the proportion of income committed to debt rises. The very sharp increase in this proportion, from as little as 5% of economic profits in the earlier period to 42% in 1982, describes the condition of fragility.

Inflation plays an important role in floating off debt where inflation exceeds the interest rate. The success of the United States in lowering its inflation rate has exacerbated the predicament of certain foreign borrowers, whose real debt is increasing. Had we chosen a tight fiscal and easy money policy, the situation would have been different.

Once the economy has acquired these turbulent characteristics, the duration of the business expansion depends on constraints and interventions. In an economy like that of the United States, with a complex financial structure, there is a tendency toward incoherence — that is, nonlinear dynamic tendencies. It is only by imposing external constraints through regulations that the incoherence is brought under control. This intervention or regulation is the job of big government or the Fed.

The national financial structure, the outstanding nonfinancial indebtedness, the domestic banking system that we have should not put any constraint on the expansion.

There's no willingness on the part of government to eliminate the structural deficit. The willingness of the Fed to constrain as the expansion proceeds is probably secondary to the international financial structure. Deregulation is likely to weaken the overall financial structure by minimizing the margins of safety on future lending. The international financial structure is the other potential constraint on the duration of the expansion. There is a problem of debtor nations earning enough local profits to pay off dollar-denominated debt.

The basic issue is that a domestic financial trauma will not take place in the relatively near future.

The important thing is that a domestic financial trauma will not occur soon, although the need to get dollar interest rates down may produce a flight from the dollar. Looking at the internal economic condition of the United States, weak trade unions, a slack labor market, continuing fiscal deficits, growing financial deregulation, the expansion could stretch out for more than the minimum additional 15 months, well into the four-year phase that we've had. However, the potential for a shortening of the expansion to stabilize falling exchange rates cannot be neglected.

The handling of international debts will be an important early indicator. A serious funding of international debt, with concessionary interest rates followed by a resumption of long-term international lending, will signal the buildup of unwanted U.S. dollars. By year-end 1983 or early 1984, we should have the first readings.

We're not in a structural situation where a large decrease in the debt burden of private corporations and private organizations in the United States can take place.

Large decreases in private-sector debt cannot occur in the United States because of the deregulation of the financial industries, the structural imbalance of the Federal government deficit, the inherited debt structure of business, and the overhang of international debt. Since a robust financial structure is a precondition for tranquil growth, we should expect continuing financial fragility and more lurching.

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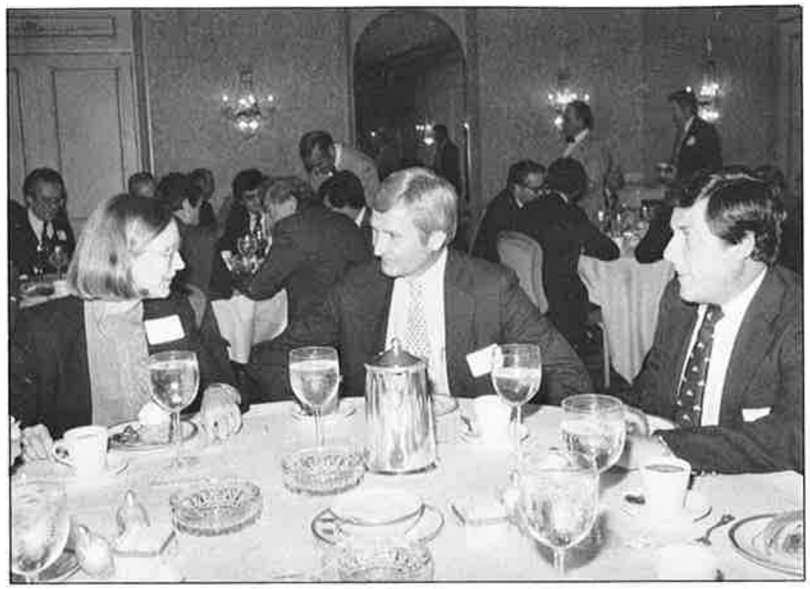

Grace Messner,
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George Austin,
Howard Hudson, Charles Larsen

Scott Weisenberger, Linda Strumpf,
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