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Introduction – Economic Prospects: Containment and Expansion

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Introduction

Economic Prospects: Containment and Expansion

Hyman P. Minsky

The papers by Robert Barbera and David Levy in this *Public Policy Brief* have as their ostensible subject the economic condition of the United States in 1991 and 1992. Their deeper subject is the determinants of the behavior of the economy. The actual current conditions analysis and forecasts are applications of a well formulated vision of what determines the behavior of the economy.

The details of a current conditions analysis of a forecast by an economist are of passing interest—events soon make the details obsolete and the accuracy of the forecast becomes the stuff of history and reputation. The permanent value of any current conditions analysis or forecast lies in the exposition of the analytic framework that is applied, and as an illustration of how that framework is used to understand events and guide policy recommendations. On both grounds, as an implicit exposition of a framework and as an illustration of the implications of the framework to policy matters, the papers in this policy brief score high.

Robert Barbera places the current economic condition in the framework of a long-term debt cycle which culminated in the untenable financial position of highly leveraged companies, Savings and Loan Associations, and banks: many of these units not only had negative cash flows but also negative net worths on a mark-to-market basis.

This situation, which marked the end of a 40-year debt expansion phase of the debt cycle, had the potential of triggering a dastardly repetition of the debacle of 1929-33. In Barbera's framework the so called bailouts of S&L's and banks were the refinancing that was needed to contain a potential financial collapse, which, if uncontained, would trigger another Great Depression. Within the framework of this model of a contained collapse, Barbera takes up the impact of the easing of market interest rates, which are due to the end of the inflation and the easy money policies of the Federal Reserve.

Robert Barbera does not simply assert that a more rapid expansion of the money supply, and the lower interest rates this promotes, leads to a recovery of the economy. What he does is trace the effects of lower interest rates upon the flows of cash through the economy and the market value of assets. The rise in asset values that comes from capitalizing a given stream of earnings at lower interest rates means that even with no improvement in cash flows, there will be an improvement in the margins of safety of the holders of financial liabilities. Furthermore, as lower interest rates work their way through the economy, the cash payment commitments of debtors decrease. This frees income to reduce debts and to finance spending.

Barbera's inimitable forecast that "cash is trash in 1992," and that this will affect longer-term interest has been borne out by events. The connection that Barbera emphasized between lower interest rates and increases in economic activity is by way of the lower cash payment commitments on debts and more favorable financing charges for new investment. The lower payment commitments on outstanding financial obligations leads to a quicker pay down of debts, and therefore, to a recovery of the ability to debt finance spending. However, for this to operate the incomes of the debtors have to be sustained.

David Levy analyses the current situation from the perspective of the "Levy doctrine" on the determination of profits: the leading determinant of profits is investment spending. Therefore, the recovery of which Barbera seems so certain is in the framework David Levy uses—conditional on investment being adequate to sustain the gross pre-interest payments capital incomes (profits) which are the cash flows that are capitalized to give capital assets value.

The core of the Levy argument is that the 1980s saw a vast overexpansion in commercial real estate and in productive capacity so that investment will be depressed by the proliferation of capital assets that are not performing according to expectations. After all, the improvement in the value of financial assets and the ability to pay down debts as debt servicing costs decline with the fall in interest rates depends upon the continuation of the capital incomes. In Levy's analysis, the overinvesting of the 1980s, combined with the indebtedness induced by financial market developments which include the new players and instruments in financial markets, means that there will be a decline in expected cash flows that offsets the lower interest rates: due to overinvestment in the 1980s, the United States will be in a depression—one which does not display the attributes of the Great Depression because of the combination of the Federal Reserve and deposit insurance interventions which sustained asset values, and the government deficit which sustained profits.

Both papers exhibit their models. They use their analytic framework to interpret data. In combination, the papers show the complexity of the paths that go from a policy of intervention such as those the Federal Reserve takes to the behavior of the economy: in economics many a slip is possible between the cup of economic policy and the lip of the performance of the economy.