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HYMAN P. MINSKY

The Federal Reserve: Between a Rock and a Hard Place

The Federal Reserve is locked into a dismal cycle whereby what it does to halt inflation can trigger debt-deflation, and what it does to prevent that debt-deflation increases inflation. Only structural reforms can release it from the cycle.

The more the Board of Governors fights inflation the worse inflation gets. The new look in Federal Reserve policy that was presented with fanfare last October was designed to enable the Federal Reserve to restrict the growth of "the" money supply, whatever that may be. According to the mainly monetarist theory that guided this action, restricting the growth of "the" money supply would lead, over a number of years, to an end of inflation. The theory is that inflation could be gradually eliminated without undue hardship.

The results of the first six months of the new policy posture are in. The record is dismal. Instead of inflation's diminishing, the rate of increase of prices has accelerated. Furthermore, during the first months of 1980 we have seen a free fall in bond prices take place which, if carried through to the books of financial institutions that hold bonds and mortgages, undoubtedly makes many leading institutions "walking bankrupts"; their net worth at market prices is negative. Overt bankruptcy has been avoided because the marketing of debt instruments at competitive interest rates has enabled walking bankrupts to fulfill maturing obligations. But such institutions are carrying assets that yield yesterday's interest rates with liabilities on which they pay today's much higher rates. Such losses on the carry mean that the walking bankrupts of 1980

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are bleeding to death.

The economic record is not all bad, however. As we recite the list of dismal indicators—inflation at more than 16 percent, interest rates above 20 percent, unemployment at 6 percent, slow growth, a dollar under continuing international pressure, and mounting trade deficits—we must recognize one overridingly important virtue of our post-World War II economy: there has not been a deep and long-lasting depression. What is more, in spite of credit crunches, liquidity squeezes, and banking debacles in 1966, 1969-70, and 1974-75, the financial system has not gone through an "interactive" debt deflation such as regularly occurred in the generations before World War II.

There is something about the structure of today's American economy that has made it immune to the financial crises and deep depressions that took place earlier in our history. At the same time there is something about its structure that makes the economy prone to accelerating inflation. The two are linked: immunity to financial crises and deep depressions is one side of a coin; susceptibility to accelerating inflation and exotic diseases like stagflation is the other. To do better in the 1980s than in the 1970s we need to understand this linkage, which means that we have to go beyond the monetarist perceptions of how our economy works.

Dual role of the Federal Reserve

Monetarist theory holds that the rate of growth of money income is determined by the rate of growth of money, and that the Federal Reserve can control the money supply to achieve noninflationary economic growth. Monetarist theory reduces the operations of a complex evolving economic system that exists in one-directional time to a matter of simple formulas that can be recited by believers and even recent converts.

In monetarist theory, the function of the Federal Reserve is to control the growth of "the" money supply to some rate derived from "the formula" on the basis of assumptions about the growth of production capacity. In truth the Federal Reserve was not brought into being to control the money supply in an effort to control the rate of growth of money income; it was brought into being in the first decades of this century because the banking and financial system experienced periodic financial crises. It was felt that a lender of last resort was needed to prevent or contain the repercussions of such crises. The Federal Reserve was to stabilize the economy by preventing debt-deflations (such as occurred in 1929-33), not by controlling the monetary supply.

Thus the Federal Reserve is both a lender of last resort, whose mission is to prevent financial instability that leads to a large-scale bankruptcy of financial institutions, and a controller of the economy, whose mission is to help steer the economy on a growth path of full employment and stable prices.

In spite of our current difficulties, the years since the end of World War II are a unique era of success in the history of the American economy in that a debt-deflation, and thus a deep depression, has been avoided. This thirty-five-year history of success falls into two parts. The first, lasting some twenty years, is a regime of rapid economic progress with—on the whole—stable prices. At no time during this period did the Federal Reserve have to intervene as a lender of last resort to maintain the financial system.

Because of the rapid accumulation of private debt and the proliferation of new institutions and instruments in financial markets during these twenty years, tranquil progress was replaced in the middle 1960s by ever-increasing financial and economic turbulence. Since 1966, the Federal Reserve has acted as a lender of last resort three times—in 1966, 1969-70, and 1974-75. Inflation, which had been a modest statistical concept prior to 1966, became a blatant, readily observable phenomenon in the 1970s.

Each time the Federal Reserve acts as a lender of last resort, it prevents some financial institution or some financial market from collapsing. When it does this, it introduces additional Federal Reserve liabilities into the economy and extends a Federal Reserve guarantee over some set of financial practices. Thus in 1966 it protected banks that used certificates of deposits, in 1969-70 it protected the commercial paper market, and in 1974-75 it extended the Federal Reserve guarantee to those who owned the liabilities of offshore branches of Ameri-

can banks. By legitimizing financial market practices through its implicit endorsement, the Federal Reserve in 1966, 1969-70, and 1974-75 set the stage for the financing of a subsequent inflationary burst.

If the Federal Reserve had not protected depositors at the London branch of Franklin National Bank in 1974 or if, after protecting such depositors, it had set prudent and constraining standards for the growth of offshore deposits at American banks, then the various increases in oil prices since 1973 could not have been sustained. Under Arthur Burns' leadership the Federal Reserve either ignored or was ignorant of a fundamental maxim of economics, namely, only that which is financed can occur. If the deposits at the offshore branches of American banks had not been allowed to expand without limit and if such deposits had been assets at risk rather than assets protected by an implicit guarantee of the Federal Reserve, the OPEC price cartel would have been broken soon after the spring of 1974.

1929 and 1979

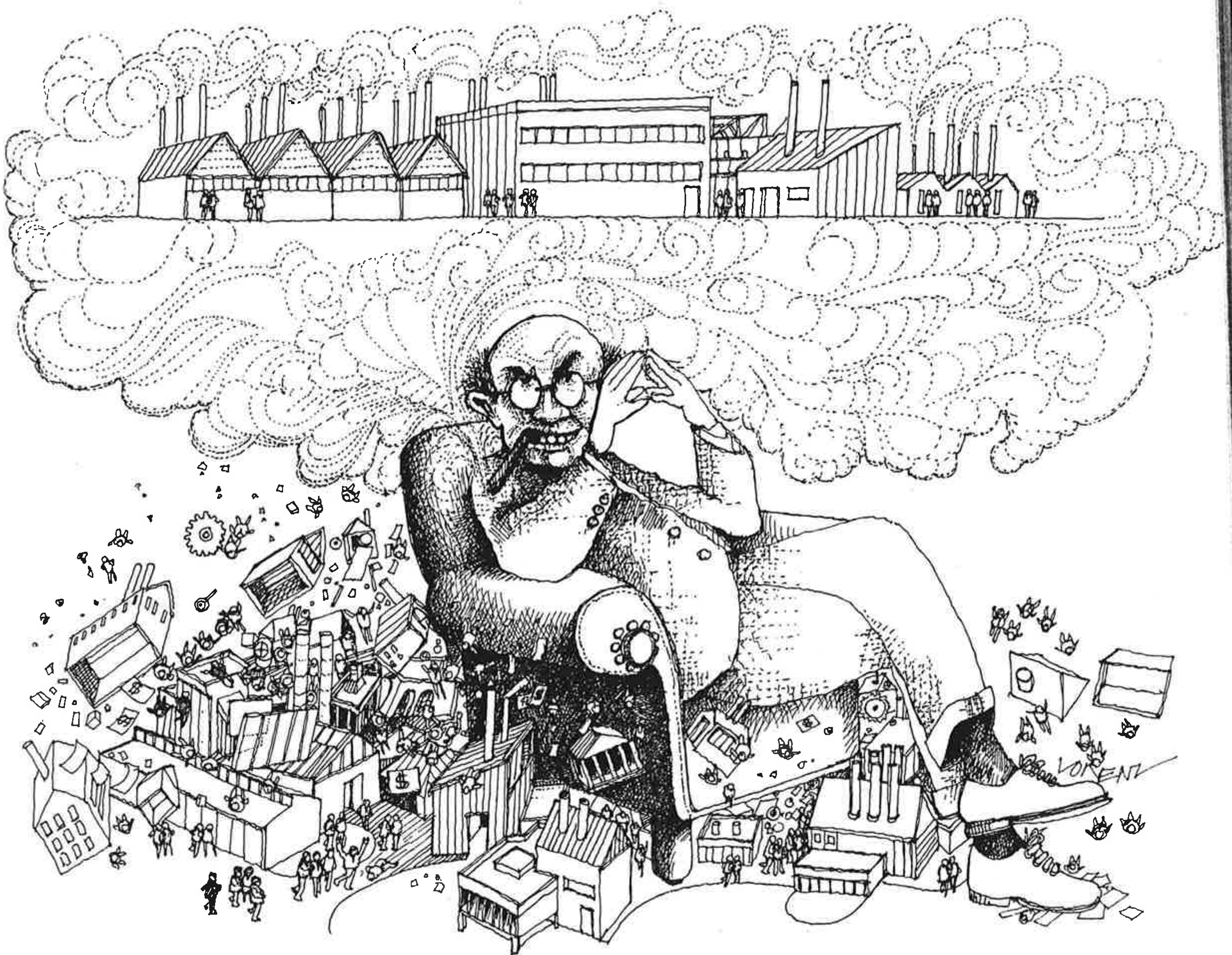
Today's American economy is much different from the economy that collapsed in the Great Depression some fifty years ago. In the accompanying table, the value of and the ratio to the gross national product of various aspects of the economy are exhibited for each end-of-decade year beginning with 1929. About the only "ratio" that has remained relatively unchanged over these years is that of investment to gross national product (15.7 percent in 1929 and 16.0 percent in 1959, 15.6 percent in 1969 and 16.3 percent in 1979). There is a myth that what is wrong with the economy is a "shortfall of investment." In truth, in 1979 we were investing, relative to GNP, at about the same rate as in earlier prosperous years.

The major changes in the composition of demand and output after 1929 are the decline in the ratio of consumption to GNP, the rise in government, however measured, and a quite recent rise in exports. If we compare the 1929 ratios of the various categories to the 1979 ratios, it is evident that the composition of demand has changed radically. There is no reason to expect an economy with small government such as ruled in 1929 (where federal government expenditures were 2.5 percent of GNP) to behave in the same aggregate manner as an econ-

Gross National Product and Its Major Components
Selected Years 1929 Through 1979

Year	Gross National Product	Consumption	Investment	Government purchase			Transfer payments to persons	Exports	Federal gov. exp.
				Total	Federal	State & local			
				Billions of dollars					
1929	103.4	77.3	16.2	8.8	1.4	7.4	.9	7.0	2.6
1939	90.8	67.0	9.3	13.5	5.2	8.3	2.5	4.4	8.9
1949	258.0	178.1	35.3	38.4	20.4	18.0	11.7	15.9	41.3
1959	486.5	310.8	77.6	97.6	53.9	43.7	25.2	23.7	91.0
1969	935.5	579.7	146.2	207.9	97.5	110.4	62.7	54.7	188.4
1979	2368.5	1509.8	386.2	476.1	166.3	309.8	241.9	257.4	508.0
				As a Percentage of GNP					
1929	100.0	74.8	15.7	8.5	1.2	7.2	.1	6.8	2.5
1939		74.2	10.3	15.0	5.8	9.2	2.8	4.8	9.8
1949		69.0	13.7	14.9	7.9	7.0	4.5	6.2	16.0
1959		63.9	16.0	20.1	11.1	9.0	5.2	4.9	18.7
1969		62.0	15.6	22.2	10.4	11.8	6.7	5.8	20.1
1979		63.7	16.3	20.1	7.0	13.0	10.2	10.9	21.4

Source: Economic Report of the President January 1980, Table B1 page 203 except Government Transfer Payments to Persons Table B18 page 223 and Foreign Government Expenditures Table B72 page 288.



omy with big government (where federal government expenditures are 21.4 percent of GNP).

How does the size of government affect the operations of our economy? Our economy is capitalist, which means that production is motivated by profits. Furthermore, in our economy, business uses debts to finance ownership of capital assets. The cash flow of business is approximately the sum of interest payments by business and gross profits after taxes or, in other words, the gross after-tax income of capital. This income is the basic source of funds that are available to meet the payment commitments on debts. For every debt structure of the economy there is a minimum level of gross profits which is consistent with any assigned level of success by business in meeting payment commitments. Below some threshold, which is determined by the size and terms on business debt, any decline in gross profits after taxes will lead to an increase in the number of businesses that fail to fulfill their contractual obligations in debts. New debt financing is always needed to sustain or expand income.

Any significant increase in the failure of business to meet payment commitments will lead to a decline in the amount of financing available to business. A decline in financing means a decline in investment, which implies a decline in income and employment.

Thus profits, broadly defined, are the pivot around which the normal functioning of an economy with private business debts revolves. It is necessary to understand what determines profits. In the heroically abstract formulations we owe to Kalecki, gross profits equal investment. If government, with its possible deficits, and the rest of the world, as reflected by the balance of trade, are taken into account, then gross profits after taxes equal investment plus the government deficit minus the balance-of-trade deficit.

In 1929 investment amounted to $16.2 billion and federal government expenditures to $2.6 billion. In 1930 investment fell by 36.4 percent to $10.3 billion and the federal government's budget swung from a $1.0 billion surplus to a $0.3 billion deficit. The change in the government deficit could not offset the $5.9 billion decline in investment, so that business gross retained earnings fell from $11.5 billion in 1929 to $8.8 billion in 1930. By this measure the cash available to fulfill payment commitments on debts fell by 23.5 percent; the burden of the debt increased as the country went into recession.

In 1979 investment was $386.2 billion and the total federal government expenditures were $508.0 billion. The effect on profits of a large decline in investment could be offset by a rise in government expenditures and a fall in taxes, which is what happened in the recession of 1975. In 1975 investment was $190.9 billion, some $23.7 billion less than in 1974. The budget deficit was $70.6 billion in 1975, some $59.9 billion greater than in 1974. As a result, business gross retained earnings were $176.2 billion in 1975, some $38.3 billion higher than in 1974. During the most serious recession of the post-war period the cash flow to business after taxes, interest, and dividends had risen by some 28 percent.

The contrast between 1929-30 and 1974-75 is striking. In 1974-75 the deficits that were caused by big government sustained business profits and enabled business to fulfill its payment commitments to banks and other financial institutions. In 1930 business had to pay debts that had been contracted for in 1929 and earlier out of a shrunken cash flow. In fact, the cash flow of business kept on contracting through 1931, '32, and into '33. In 1929-33 the burden of debt inherited from the past increased. In 1975, even as the economy was in its most severe recession of the post-World War II era, the burden of inherited business debt decreased.

In an economy with the 1929 structure a shortfall of profits can take place which makes it difficult or impossible for business to fulfill its obligations on debts. No such shortfall can happen in an economy with the 1979 structure of demands. With the 1979 structure, the impact on profits of a fall in investment will be offset by a rise in the government deficit: the amplitude of the fluctuation in profits will at a minimum be decreased—at a "maximum" it may disappear or even become "contracyclical."

The automatic and discretionary fiscal reactions of 1974-75 were not the only governmental interventions that prevented a deep depression. In May of 1974 a run took place on the money market liabilities of Franklin National Bank. The Federal Reserve Bank of New York opened its discount window to the Franklin National, which allowed it to pay off maturing liabilities. In October 1974 Franklin National Bank was closed. In a period of slightly more than two years, 1973-75, four banks in the billion-dollar class required special assistance from the Federal Reserve and two failed. In addition, in the same period a sizable number of smaller banks failed and there were widespread overt and covert failures by Real Estate Investment Trusts. The spate of failures did not lead to an interactive collapse because the lender-of-last-resort interventions by the Federal Reserve and other government agencies prevented the process by which each failure triggers several other failures.

Lender of last resort

The Federal Reserve wears two hats. One hat signifies the operator of monetary policy. When the Federal Reserve wears this hat its target is noninflationary growth. The second hat is that of lender of last resort. When the Federal Reserve wears this

hat it is actively refinancing and funding the debts of units whose ability to raise finance on commercial terms has been compromised. The lender-of-last-resort actions feed reserves into the banking system and set limits to the default risks carried by holders of liabilities that the Federal Reserve protects. Both the feeding of reserves into the private financial system and the extension of Federal Reserve guarantees increase the ability and willingness of banks and other financial institutions to finance activity. If lender-of-last-resort interactions are not accompanied by regulations and reforms that restrict financial market practices, then the intervention sets the stage for the financing of an inflationary expansion, once the "animal spirits" of business people and bankers have recovered from the transitory shock of the crisis that forced the lender-of-last-resort activities in the first place.

The Federal Reserve therefore is in a dilemma. It is dealing with a very sophisticated and convoluted financial system in which the available financing is responsive to demand. The existence of this complex system means that a great many payments have to be made among the financial institutions and that a set of financial relations exists that depends upon the availability of bank financing as a "fall-back" source of funds. The Federal Reserve can bring a halt to an inflationary process only as it forces high enough interest rates so that units which need refinancing are found to be ineligible for financing in the market because of inadequate expected profits or cash flows. The Federal Reserve can break an inflationary process only by first creating "walking bankrupts" and then transforming them into overt, open bankrupts. When walking bankrupts, deprived of bank or other normal financing, try to meet payment obligations by selling assets, a collapse of asset values occurs. When this takes place, an epidemic of bankruptcies is set to erupt. Since the mid-1960s the Federal Reserve has been able to force a contraction only as it has taken the economy to the brink of financial crisis. In 1966 the Federal Reserve forced both a virtual run on bank certificates of deposit, and disorderly conditions in the municipal bond market. In 1969-70 it broke an inflationary expansion by forcing the disruption of the commercial paper market. In 1974-75 it reined in an inflation by allowing money market conditions to develop which led to widespread bank failures (Franklin National was not alone) and the virtual liquidation of the $20-billion Real Estate Investment Trust financial industry.

Disorderly conditions and widespread overt or covert failures in financial markets draw forth lender-of-last-resort intervention. The Federal Reserve intervenes to halt that which it has triggered. Intervention and government deficits set the stage for a subsequent inflationary expansion. The seeds of the Carter inflation of 1979-80 were planted in 1975 and 1976, during the Ford administration, when the government ran a $70-billion deficit and the Federal Reserve did not follow up on its lender-of-last-resort interventions by placing effective constraints on the overseas operations of United States banks.

The need for structural reforms

Is there an alternative to this dismal cycle in which what is done to halt an inflation triggers a debt-deflation and what is done to abort a debt-deflation and deep depression leads to a subsequent inflation? The argument above makes it evident that controlling money is not sufficient; if we are to bring a halt to the dismal cycle, far-reaching structural reforms are needed.

The instability of the American economy, so evident since the middle of the 1960s, has been accompanied by widespread deterioration as measured by the rate of economic growth, the path of real wages, unemployment rates, the trend in the exchange rate of the dollar, and the status of the dollar as an international currency. Such multidimensional malfunctioning indicates that comprehensive reform is needed; there is no "magic bullet" that can cure what now ails the economy.

Our present economic structure was largely put into place during the first Roosevelt administration. During those creative years, institutional arrangements were established which aimed at preventing any recurrence of the kinds of disastrous wage and price declines that had taken place in 1929-33. Many of the reforms were consciously designed to raise prices. In 1933, an inflation which returned prices at least partway to the 1929 level was much

desired; such a "reflation" would lower the inherited debt burden.

The Roosevelt reforms took place in an intellectual vacuum that followed the failure of the then standard economic theory, and thus the inability of the day's leading economists to understand American capitalism and to develop effective programs for controlling and reversing the great contraction. Keynes' *General Theory*, which explained why capitalist economies have great depressions and which offered programs to cure and then prevent such disasters, had not as yet appeared.

Since World War II, a vulgar form of Keynesian demand management policies has been used in an economy whose structure largely reflects devices adopted in pre-Keynesian days to prevent prices and wages from falling. Once experience shows that if government is big enough so that swings in the deficit can compensate for the effects on aggregate demand and profits of swings in investment, then structural devices like those introduced in the 1930s to prevent wage and price declines become counterproductive. These devices lead to the absorption of a large part of demand, sustaining and increasing monetary and fiscal actions by price increases. Stagflation followed by accelerating inflation is the result of demand management policies within a capitalist economy that is characterized by large-scale grants of market power to firms, financial organizations, and labor alongside inefficient transfer payment schemes which push presumed "beneficiaries" out of the labor force.

The analysis above enables us to discern the contours of the reforms that are needed. Big government remains necessary to prevent a shortfall of investment from triggering an interactive debt-deflation process, but it can be considerably smaller than the present government, and it can be different. Reform of the transfer payment system is needed, not as a punitive measure against the poor, the old, and the infirm, but to introduce flexibility and remove barriers to work. Children's allowances should be granted by right, replacing both the income tax deduction for children and the aid to families with dependent children. In this way, adult "beneficiaries" of welfare can be in the labor force. At the same time, the provisions of the Social Security Act that set up barriers to income from work should be eliminated.

Beginning with the National Recovery Act, (NRA), the Roosevelt administration followed soft anti-trust policies; this softness was interrupted for a brief period in 1937-38. In order to constrain the inflationary absorption of income maintenance measures, the private market power of giant corporations must be "broken." A structure of industry policy which emphasizes the control function of competitive markets is an essential element in any package of reforms designed to eliminate the dismal cycle of the 1970s. Such reforms would not only set limits on the resources controlled by any private center of power, but would also entail changes in the tax laws which eliminate the present corporate income tax and the employer "contribution" to Social Security, both of which induce a substitution of capital for labor.

The crisis in financial markets in the spring of 1980 makes it clear that private business cannot finance capital-intensive industries such as railroads and nuclear power, which have social benefits and costs that are not reflected in market prices and costs. Public ownership and operation of such industries is needed; paradoxically, perhaps, private ownership capitalism does not work well for industries of extreme capital intensity.

The change from the tranquillity and progress of the first two decades after World War II to the turbulence and stagnation of the past fifteen years is clearly related to the emergence of the fragile financial structure that led to crunches, squeezes, and debacles in financial markets. There should be a basic restructuring of the financial system so as to promote smaller and simpler organizations weighted more toward direct financing than they now are.

Of course, the reforms suggested above do not constitute a program to resolve the present crisis of inflation and financial disarray. The economy is on a path that leads to a longer and deeper replication of 1974-75. Before we can do better we must understand our economy. Unfortunately, policymakers and advisors are the slaves of an economic theory that misspecifies the nature of our economy by ignoring its instability. That perhaps is a true measure of our crisis: nobody "up there" understands American capitalism.