Between a Rock and a Hard Place:

The Federal Reserve in 1980.

by

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The more the Board of Governors fights inflation the worse inflation gets. The new look to 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 getting better, 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 in the carry mean that the walking bankrupts of 1980 are bleeding to death.

However the economic record is not all bad. As we recite the list of dismal indicators -- inflation at more than sixteen percent, interest rates above seventeen percent, unemployment at six percent, slow growth, a dollar under continuing international pressure, and mounting trade deficits -- we need recognize one overridingly important virtue of our post World War II economy: there has not been a deep and long lasting depression. Furthermore 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 which has made it immune to financial crises and deep depressions such as took place earlier in our history. At the same time there is something about the structure of the 1970's American economy which made it prone to accelerating inflation. The two are linked: immunity to financial crises and deep depressions is the one side of a coin, susceptibility to accelerating inflation and exotic diseases like stagflation is the other. To do better in the 1980's than in the 1970's we need to understand this linkage, which means that we have to go beyond the monetarist perceptions of how our economy works.

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 which 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 full employment-stable prices growth path.

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 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.

This first period of tranquil progress was replaced in the middle 1960's by ever increasing 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 1970's.

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 the owners of liabilities of offshore branches of American 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 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, which is 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 were 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.

Today's American economy is much different than the economy that collapsed in the Great Depression some fifty years ago. In the accompanying table the value of and the ratio to G.N.P. 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 G.N.P., at about the same rate as in earlier years.

The major changes in the consumption of demand and output after 1929 are the decline in the ratio of consumption to Gross National Product, 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 that an economy with small government (Federal Gov. Exp. 2.5 percent of G.N.P.) such as ruled in 1929 to behave in the same aggregate manner as an economy with big government (Federal Gov. Exp. 21.4 percent of G.N.P.) such as rules now.

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 and the cash flow of business -- is the principal 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. In as much as new debt financing is always needed to sustain or expand income, any significant

Table I

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 G.N.P.									
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.

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 due to Kalecki gross profits equals 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 equals investment plus the government deficit minus the balance of trade deficit.

In 1929 investment was 16.2 billion dollars and Federal Government Expenditures were 2.6 billion dollars. In 1930 investment fell by 36.4 percent to 10.3 billion and the Federal Government's budget swung from a 1.0 billion dollar supplus to a 0.3 billion dollar deficit. The change in the government deficit was not able to offset the 5.9 billion dollar decline in investment, so that business gross retained earnings fell from 11.5 billion dollars in 1929 to 8.8 billions in 1930. By this measure the cash available to fulfill payment commitments on debts fell by 23.5 percent; the burden of the debt increasing as the country went into recession.

In 1979 investment was 386.2 billion dollars and the total Federal Government Expenditures were 508.0 billions. 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 dollars, some 23.7 billions less than in 1974. The budget deficit was 70.6 billion dollars in 1975, some 59.9 billion dollars greater than in 1974. As a result business gross retained earnings were 176.2 billion dollars in 1975, some 38.3 billions higher than in 1974. During the most serious recession of the post-war period the cash flow to business after taxes, interest, and dividends rose by some 28 percent.

The contrast between 1929/30 and 1974/75 is striking. In 1974/75 the deficits that were caused by the big government that was in place 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 as a minimum be decreased -- as 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 period a sizeable 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 from gaining momentum.

The Federal Reserve wears two hats. One hat is the operator of monetary policy. When the Federal Reserve wears this hat its target is noninflationary growth. The second hat is as the 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 increases the ability and willingness of banks and other financial institutions to finance aciivity. If lender of last resort interactions are not followed by regulations and reforms that restrict financial market practices then the lender of last resort intervention sets the stage for the financing of an inflationary expansion once the "animal spitits" of business men and bankers recover from the transitory shock of the crisis that forced the lender of last resort activities.

The Federal Reserve therefore is in a dilemna. It is dealing with a very sophisticated and convoluted financial system in which the available financing is responsive to demand. The existence of this convoluted financial system means that a great deal of payments have to be made among the financial institutions and that a set of financial relations exists which depends upon the availability of bank financing as a "fallback" 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 walking bankrupts into overt, open bankrupts. When walking bankrupts, deprived of bank or other normal financing, try to make position by selling assets a collapse of asset values
When this takes place, an epidemic of bankruptcies is set to erupt. Since the mid 1960's the Federal Reserve has been able to force a contraction only as it as been able to first force disorderly conditions in some financial markets or the failure and near failure of a wide array of financial organizations.

Disorderly conditions and widespread overt or covert failures in financial markets draws forth lender of last resort intervention. The Federal Reserve intervenes to halt that which it triggered. Lender of last resort intervention and the government deficit set the stage for a subsequent inflationary expansion. The seeds of the Carter inflation of 1979/80 were planted by the Ford administration in 1975 and 1976.

Is there an alternative to this dismal cycle in which that which is done to halt an inflation triggers a debt-deflation and that which is done to abut a debt-deflation and deep depression leads to a subsequent inflation? From the above argument it is evident that controlling money is not sufficient; if we are to bring a halt to the dismal cycle far-reaching structural reforms are needed. Whereas big government is necessary to prevent a shortfall of investment from triggering an interactive debt-deflation process big government and especially increasing government imparts an inflationary bias to the economy. Thus a government that is big but smaller than the present government is needed.

Between 1969 and 1979 Federal Government transfer payments to individuals rose from 62.7 billion dollars (6.7 percent of G.N.P.) to 241.9 billion dollars (19.2 percent of G.N.P.). Reform of Social Security, not as a punitive measure but as designed to truly better the lot of the aged by introducing flexibility and removing the barriers to working is necessary. Symmetric reforms of other transfer payments are needed.

Between 1969 and 1979 exports increased from 5.8 percent to 10.9 percent of Gross National Product. To an exporting and importing country the exchange value of the currency is important. It cannot be treated as a slack variable that takes on whatever value "the market" assigns. A stable and even an appreciating dollar within a regime of free trade should be an objective of policy. This implies wage rate stability not as a sacrifice by labor but as a way of fairly assuring to labor the benefits of productivity growth.

In order to assure that the benefits of productivity increases are widespread, 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 reform designed to eliminate the dismal cycle of the '70's. It is naive to assume that if market power exists it will not be used. It is also true that the best of monopoly power is an easy life. The obvious development of comparative inefficiency by the American economy, as witnessed by the poor productivity record, is related to the abandonment over the post war years of any attempt to control the inefficiencies that are inevitable consequence of private market power.

Furthermore the change from the tranquility 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 the crunches, squeezes and debacles in financial markets. We need a basic restructuring of the financial system that leads to simpler organizations with a larger weight to direct financing than now exists.

The above are some items on an agenda for reform but obviously they are not a guide to the operations of economic policy within the existing institutional structure. Perhaps the lesson to be learned for current policy from the above argument is that economic policy must reflect an understanding that our economy as it now exists in unstable, that this instability is due to the nature of the financial system and that the Federal Reserve is figuratively between a rock and a hard place in that what it does to halt an inflationary expansion will trigger a debt-deflation and that when it intervenes as a lender of last resort to halt a debt deflation it will - unless reforms of the financial structure follow the lender of last resort intervention - set the stage for a subsequent inflation. Big government and todays Federal Reserve are a blessing when they prevent debt deflations and deep depressions - they are a curse when they set the stage for accelerating inflation. Before we can do better we must understand our economy. Unfortunately policy makers and advisors are the slaves of an economic theory that misspecifies the nature of our economy. That perhaps is the true measure of our crisis: there is nobody "up there" who understands American capitalism.