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The Fragile Financial System

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'Fragile' Financial System Risks Crisis, Deflation; Debt Reduction Essential

By HYMAN P. MINSKY

Can the current two-digit and accelerating inflation be brought under control without first going through a financial crisis and a debt-deflation process? History indicates that a financial crisis followed by a debt deflation process is associated with a deep depression.

Can we get off the back of the inflation tiger without becoming the depression "smile"?

Underlying the view that the choice before us is either continuing unacceptable rates of inflation or a financial crisis followed by a deep depression is the feeling that the financial structure is now fragile. A financial system is fragile when:

- a. The ratio of cash-flow commitments on debts is high relative to the cash-flow receipts from operations or contract fulfillment.
- b. A large proportion of units are speculative in the sense that the cash-flow receipts from operations or contract fulfillment cannot meet the payment commitments, that is, "debt" is short-term relative to "assets" so that refinancing is necessary.
- c. And the ratio of cash and readily marketable financial assets is low relative to financial assets or financial liabilities.

The data in the accompanying tables indicate that the trend since World War II has been from financial robustness to financial fragility. The financial structure is now considerably more fragile than early in the postwar epoch.

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In a fragile financial structure, policy actions taken by the Federal Reserve in an attempt to constrain demand will cause serious financial disruptions of a financial market or of a particular financial institution before it causes the desired reduction in demand.

Such crisis episodes occurred in 1966, 1970, and apparently again in 1974.

In each case, the Federal Reserve put on its lender-of- last-resort hat and went to the support of the threatened market or institution. But, by being an effective lender of last resort, the Federal Reserve in effect abandons its effort to control aggregate demand. This is true for two reasons:

- The process of being a lender of last resort means that the Federal Reserve feeds reserves into the banking system.
- By protecting a financial institution, instrument, or market that is under crisis pressures, the Federal Reserve legitimizes and validates practices which in effect increases the ability of the economy to carry "debt."

In the mini-crisis of 1966, the Federal Reserve validated negotiable CDs. In the mini-crisis of 1970 the Federal Reserve protected and legitimized the commercial paper market. And in the current situation it seems to validate banking with "bought" money.

The Federal Reserve's actions as a lender of last resort assure that in the next recovery, the now legitimized new instrument will become generalized. Thus the amount of financing available on a given reserve base increases as the Federal Reserve protects these new usages and practices.

The Federal Reserve is damned if it allows a financial crisis to proceed, thus deliberately accepting a depression, and damned if it does not, deliberately choosing accelerating inflation. I believe it is no accident that inflation began to accelerate in the middle 1960s around the time of the credit crunch, and further accelerated after the Penn-Central/commercial paper market crisis of 1970.

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One measure of the robustness or fragility of the financial structure is the ratio of cash flow from operations (gross profits after taxes on corporations) to the cash payment commitments on account of debt. Thus, an inflation which increases the flow of corporate profits relative to debt payment commitments does make the financial system more robust. The Federal Reserve's rescue operations not only prevent a debt deflation process but actually set the stage for a vigorous inflationary expansion.

If we are to get off the inflationary tiger without a depression, we will need to change our fundamental policy strategy. The policy strategy which developed after the war has three dimensions:

- An emphasis upon economic growth by way of private investment.
- A system of government contract expenditures not only in defense and space but also in roads and housing.
- An emphasis on increasing transfer payments.

It is important to note that the contract system and transfer payments have an inflationary bias on their own. The current pace of inflation is in my mind not unrelated to the fact that transfer payments increased by some 70% during the first five years of the Nixon administration.

The fact that our Social Security system is an economic monster which needs reform is, I believe, becoming a common view. What is not understood is that it is in and of itself an inflationary factor.

The contract system leads to an entire set of enterprises whose profits are guaranteed by government. These enterprises tend to go along with inflationary wage increases, and are effective lobbyists for government intervention to protect their positions.

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Is there any way in which the financial system can be made more robust without going through a debt deflation process and a depression? A debt-deflation process followed by a depression makes a fragile financial system more robust by first wiping out debt and then permitting cash flow to corporations and households to exceed in the aggregate the expenditures of these sectors on investment.

In such a situation, households and firms run financial surpluses, and the government runs a deficit. By way of contrast in the current contract system, government deficits generate profits and profit expectations which tend to generate speculative investments. Thus during a period in which the effort is to make the financial system more robust, government spending should not conform to its present pattern.

What we have to do is to abandon the growth - through - private - investment policy strategy and deliberately discourage external financing of private investment. Similarly, household debt - financed expenditures — especially on housing—needs to be discouraged. The entire series of government tax and subsidy arrangements which encourage private investment and housing need to be abandoned. Inducement to corporations to clean up their liability structures should be built into the tax and regulatory schemes. Tax and other subsidies to housing construction should be abandoned.

Of course, unless something is put in their place, the reduced expenditures on private investment, housing, and government contracts will result in large scale unemployment. I therefore propose that we replace these items by schemes of direct employment of people by government agencies.

We should resurrect the W.P.A., C.C.C., and N.Y.A. of the depression—and maintain jobs through direct government employment. Since direct government employment could provide jobs for all, this change in policy strategy would also enable us to get the transfer-payments mess under control.

What I propose is that we purposefully shift policy to institute the financial situation of a depression characterized by low investment and high acquisition of liquid assets—that we, so to speak, have a depression without a depression.

I, of course, do not expect us to do what I suggest. Growth, housing and transfer payments are sacred cows. I, therefore, expect the Federal Reserve and the Treasury to "valiantly" fight off the threats of financial crisis, to devise new ways of externally financing investment, and to continue clinging to the back of the inflationary tiger. There may be a period of floundering during which we may even have a recession that is deep by post-war standards.

However, unless we reconstitute a robust financial structure in a manner which does not mean that marginally increased robustness induces inflationary debt-financed expenditures by business and households, I expect that we will go through another round or two similar to those we have experienced over the past decade.

There is, incidentally, an alternative. Businessmen and their bankers may become so "frightened" by the current financial stringency that on their own they develop a new consensus of what is apt in financial structures. They could constrain debt-financed expenditures until a more robust structure is achieved.

However, even as I state this alternative, I realize the futility of expecting such constraint. ■

In the mini-crisis of 1966 the Federal Reserve validated negotiable CDs, and in the mini-crisis of 1970 the Fed legitimized and protected the commercial paper market.

Dr. Minsky is professor of economics at Washington University, St. Louis. This is his talk in New York to the National Association of Business Economists.

Measure of Financial Robustness-Fragility Commercial Banking

(Selected Years, 1951-1972)

Year	No Default Risk Assets* / Total Assets	Bought Funds† / Total Liabilities
1951	54.2%	3.6%
1956	43.2	4.7
1961	36.8	6.9
1966	24.2	14.6
1971	20.6	17.2
1972	19.0	19.5

* Vault cash, Deposits at Federal Reserve Banks, and Government Securities.

† Large Denomination CDs, other Interbank Claims, Credit Market Debt, Liabilities to Foreign Affiliates, Borrowing at Federal Reserve Bank and "other" Liabilities.

Source: Board of Governors of the Federal Reserve System: "Flow of Funds Accounts 1945-1972" (Aug., 1973).

Fixed Investment as Ratio To Gross Profits After Taxes Non-Financial Corporations

(1946–1973)

Year		Year	
1946	1.53	1960	1.05
1947	1.27	1961	.99
1948	.98	1962	.94
1949	.89	1963	.94
1950	1.07	1964	.92
1951	1.07	1965	.97
1952	1.05	1966	1.02
1953	1.13	1967	1.05
1954	1.01	1968	1.13
1955	.91	1969	1.27
1956	1.07	1970	1.35
1957	1.12	1971	1.25
1958	1.01	1972	1.21
1959	.94	1973	1.30

Source: Board of Governors of the Federal Reserve System. "Flow of Funds Accounts 1945-1972 (Aug., 1973) plus preliminary data for 1973.

Measure of Financial Robustness-Fragility Households

(Selected Years, 1951–1973)

Year	Liabilities / Disposable Personal Income	Liabilities / Demand Deposits	Liabilities / Protected Assets	Corporate Equity / Total Financial Assets
1951	37.8%	1.42	42.9%	32.2%
1956	55.0	2.38	63.4	40.5
1961	66.7	3.19	73.5	44.9
1966	72.4	3.94	78.7	50.4
1971	69.8	3.63	71.9	39.4
1972	74.0	3.77	72.7	40.1
1973	79.3	4.08	76.4	33.1

Source: Board of Governors of the Federal Reserve System: "Flow of Funds Accounts 1945-1972" (Aug., 1973) plus preliminary data for 1973.

Measure of Financial Robustness-Fragility Non-Financial Corporations

(Selected Years, 1951-1972)

Year	Cash Flow* / Total Liabilities	Total Liabilities / Demand Deposits	Protected Assets** / Total Financial Assets
1951	17.16%	5.33	41.1%
1956	17.06	6.47	32.1
1961	14.95	9.14	26.2
1966	16.84	13.12	19.2
1971	11.98	16.60	15.8
1972	12.08	18.20	14.8

* After Dividends and Taxes

** Demand Deposits, Time Deposits and U.S. Government Securities.

Source: Board of Governors of the Federal Reserve System: "Flow of Funds Accounts 1945-1972 (Aug., 1973).

E. Jeffery Couch

Citizens & Southern VP

E. Jeffery Couch has been promoted to vice president and manager of the bond department at Citizens & Southern National Bank in Atlanta.

The department will be responsible for the underwriting and sale of municipal, Government, and Federal agency securities to banks, corporations and individual bond customers throughout the Southeast.

Prior to his promotion, Mr. Couch was manager of a sales unit in the bond department. He joined C&S in 1963, and he has worked in charge account service, credit, and the bond department.