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1973

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Recommended Citation
Minsky, Hyman P. Ph.D., "Some Aspects of Banking and the Economy Over the Past Decade" (1973). *Hyman P. Minsky Archive*. 352.
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Some Aspects of Banking and the Economy Over the Past Decade

by

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I. Introduction

The occasion of this meeting--the tenth anniversary of the founding of Mark Twain South County Bank--makes this an appropriate time and place to review some developments that have taken place over the past decade in banking, finance, the economy, and our way of looking at the economy.

This review is not being undertaken as an exercise in history, but rather as an examination of whether the recent past can serve as a guide to the near future. It has been said that we must know the past in order to avoid repeating the mistakes of the past. It is equally important to know how the present differs from the past, so that we will not expect the future to be a statistical extrapolation of the past.

Of necessity the review of the past decade that follows is highly selective. The conclusions I draw from it are:

(1) The Federal Reserve adequately met the challenge posed by the emerging instability of the financial system and on two occasions successfully aborted incipient financial crises.

(2) The Federal Reserve cannot really control the effective quantity of money inasmuch as the economically significant money supply is determined by the innovative response of bankers and business.

(3) Those doctrines of economic policy which go under the ruberic of monetarism essentially miss the point about how American Capitalism works.

Over the past decade the United States has experienced a series of debilitating shocks to its self image: the assassination of President Kennedy, the Vietnam War, and the ongoing Nixon horrors are but the traumatic highlights. Nevertheless the narrowly defined economic indices show that in this era of emotional trial, the economy

in the aggregate did quite well. Furthermore the prognosis for next year is that if the energy crisis allows private investment, income and employment will be strong. The political and social disasters have not as yet destroyed the basic optimism--or Animal Spirits--that is the psychological prerequisite for continued prosperity.

At this point an aside may be in order. The United States is now faced with two serious challenges, and much depends upon our response. These challenges are (1) the radical change in relative prices which reflects the emerging world-wide shortages of food and fuel and (2) the impact of the trauma of the decade, and most especially Watergate, upon the self-confidence and self-image of the country.

The developing shortages, which today are most strikingly evident in the "energy crisis" indicate that the next era will witness substantial changes in our ways of living and doing. If our national policies do not facilitate changes which economize on the now more strikingly scarce resources, if we try to expand fuel supplies at any cost rather than equitably adjust demand to the new realities, and if we adopt a "Micawber" frame of mind, hoping that something will turn up in the way of new technology, then our response will only serve to make things worse. All out crash programs of supply expansion and search for simple solutions in the form of new energy sources will only impoverish the country, and might well entail a pattern of cross-subsidization that places an unconscionable share of the adjustment costs upon the non-affluent. If our response to the current crises are not creative, if we try to "freeze" or even expand the "life styles" that have dominated the post-war period, if we cast our lot with old views, tired solutions, and empty slogans, then the developments in energy, food, and basic raw material costs might well lead to a long lasting stagnation of the American Economy.

Historical analogies are froth with pitfalls, but the problems the United States will face after Nixon may well be likened to those that Britain faced in the aftermath of the First World War. In that war Britain not only lost a generation of potential leaders, as we did in the Vietnam, drug, and rebellion scene of the late 1960's, but it

also lost its self esteem. The war showed that Britain's generals and political leaders were both incompetent and deeply corrupt. The idea of progress, which had permeated the late Victorian and Edwardian ages, was viewed in the 1920's as a youthful naivety. Cynicism, a failure of entrepreneurial nerve, and an attempt to live in a style inconsistent with economic and political realities characterized Britain's response to the problems it faced after World War I. The sharp class conflicts that have shackled Britain for the past fifty years are rooted in the sterile, backward-looking response of Britain to the disaster of World War I. In a meaningful sense the stagnation induced by the failure of Britain to face up to its problems in the 1920's has lasted to today.

If the Nixon disaster lasts long enough to instill a cynical view of the honesty and competence of our leadership, if a backward-looking wheeling and dealing political and economic environment is sustained, if the response to our new relatively impoverished position in the world is based upon the childish belief that if unpleasant facts are ignored they will "go away," then it is quite likely that a long lasting stagnation will set in: the evils that are exemplified by Nixon's Watergate will live long after Nixon's time in office.

II. A Perspective on Banking

Banking underwent some marked changes during the past decade. In interpreting banking history and in attempting to envisage future developments the principle stated by Professor H. Simons of Chicago is most relevant:

> "Banking is a pervasive phenomenon, not something to be dealt with by legislation directed at banks. The experience with the control of note issue is likely to be repeated in the future: many expedients for controlling similar practices may prove ineffective and disappointing because of the reappearance of prohibited practices in new and unprohibited forms. It seems impossible to predict what form the evasion might take or to see how particular prohibitions may be more than nominally effective." 1/

1/ Henry Simons, "Rules vs. Authorities in Monetary Policy," AEA Readings in Monetary Theory, pp. 353-354.

In particular the evolution of banking in response to profit opportunities introduces elements of instability into the economy.

Banks are organizations which specialize in the financing of activity which requires borrowing and lending. Banking encompasses many types of organizations, not only those formally chartered and regulated as banks.

An economy in which banking is important, i.e. in which borrowing and lending is the way of life, will behave quite differently from an economy in which such activity is rare or does not occur. In particular, borrowing and lending introduce elements of instability into an economy. The business cycles of experience are related to financing of activity by debt and the impact of the legacy of the past debt financing.

The pervasiveness of banking means that banking is an ever evolving business. The stimuli for the evolution of banking come from developments in the economy and technical and entrepreneurial developments in finance. If what we call banks are asleep to opportunity, either because of management deficiencies or a poorly advised regulatory climate, then the evolution of "banking" will mainly take place outside the organizations officially labeled as banks, if "banks" are alert, aggressive, and profit-oriented then interesting financial developments will take place within the formally organized banks.

Although many interesting developments took place within the formally organized banks during the past decade, in this paper I will look at only one, the relative growth of non-member and member banks. I do this because the relatively rapid growth of non-member banks throws light on banking theory and how banking interacts with the rest of the economy--i.e. it illuminates both economic theory and the theory of economic policy.

I will also look at but one development outside formally organized banks--the growth and nature of the commercial paper market. There are two reasons for doing this: commercial paper shows that the definition of money that is used by many economists is arbitrary, and in June of 1970, when the United States came close to having a classical financial crisis, the particular market at risk was the commercial paper market.

In the first part of the post-war period, up to, perhaps, 1960, banking seemed to be a mature industry, doing usual or accepted things in standard ways. Beginning about 1960, when the negotiable certificate of deposit was introduced, banking became a much more interesting, competitive, and innovative industry. The transition to what is called "liability management banking" was much more than a shift of emphasis from one to the other side of the balance sheet; it also signaled a more aggressive and innovative view of how banks can function. Banks now operate over more dimensions of the sophisticated system of borrowing and lending that characterizes our economy than hitherto in the post-war era.

The past decade conveniently breaks down into three parts: the first part is a regime of accelerating financial development which led to an investment boom and culminated in the credit crunch of 1966, the second part consists of a strong recovery from the credit crunch and leads to another near financial crisis in 1970 (the Penn-Central, commercial paper market crisis), and the third continuing part includes the 1970-71 recession and the strong inflationary burst of 1973.

The following table, which shows rates of growth of nominal G.N.P. over this period, indicates that the "task" of banking, as measured by the money value of economic activity, grew at a rate of 7.5% over the decade 1962-72 and that the deviations from this decade average over the subperiods were not excessive. The first of the periods, 1962-66 is characterized by modest inflation rates, the second and third periods is characterized by a more evident inflationary thrust.

II. Growth of Member and Non-Member Banks

The decade 1962-72 saw total bank assets grow at a vigorous 9.5% annual rate, substantially greater than the 7.6% annual rate of growth of nominal G.N.P. Over this period total assets of member banks grew at an 8.9% annual rate whereas total assets of non-member banks grew at a 12.4% annual rate. As a result the percentage of bank assets in non-member banks grew from 15.5% to 20.1% of insured bank assets. Non-member banks now hold a substantially greater portion of total bank assets than was true a decade ago.

Growth Rates of Various Financial and Economic Variables
(1962-1972 and selected sub-periods)

Annual % Growth Rates

	1962-66	1962-70	1970-72	1962-1972
Nominal Gross National Product	7.6%	6.8%	8.6%	7.5%
Bank Assets				
Member Banks	7.6%	8.6%	12.1%	8.9%
Non-Member Banks	9.6%	12.8%	17.5%	12.4%
Bank Capital				
Member Banks	7.3%	6.7%	9.9%	7.6%
Non-Member Banks	8.4%	9.7%	19.6%	11.0%

The rate of growth of both member and non-member banks accelerated as the decade wore on. In the period of relatively non-inflationary growth, leading up to the credit crunch of the fall of 1966, member banks total assets grew at a 7.6% annual rate, whereas non-member banks' assets grew at 9.6%. In the period between the crunch and the Penn-Central crisis, member banks' assets grew at an 8.6% annual rate, and the assets of non-member banks grew at a 12.8% rate. In the post-squeeze era, member banks total assets grew at a 12.1% rate and non-member banks' assets grew at a phenomenal 17.5% annual rate.

Clearly, non-member banks have grown at a faster rate than member banks over this period, and in each of our sub-periods. One reason for this relatively greater rate of growth of non-member banks has been the increase in the proportion of non-member banks in total banks: 53.9% of the banks were non-members in 1962, whereas 58.4% were non-members in 1972. The average size of a member bank in 1962 was 41.2 millions, whereas the average size of a non-member bank was but $6.45 millions. In 1972 the average size of a member bank was $102.6 millions whereas the average size of a non-member bank was $18.3 millions. That is, over the decade the average size of a member bank grew by 4.1% per year, whereas the average size of a non-member bank grew by 6.3% per year. Clearly not only did the number of non-member banks increase relative to member banks, also a typical non-member bank apparently grew more rapidly than a representative member bank.

Thus the relatively greater growth of non-member banks can be imputed to two causes: the increase in the proportion of non-member banks as well as a relative increase in

their size. This is evidence that non-member banks have been profitable, and apparently increasingly so, over the period. The success of the non-member banks in attracting capital is additional evidence of their profitability. Whereas the capital accounts of member banks grew at an annual rate of 7.6% over the decade, the capital accounts of non-member banks grew at an annual rate of 11.0%. In the last two years of the decade, 1970-72, the capital accounts of non-member banks grew at an annual rate of 19.6%.

The growth of non-member bank capital over this period has been the result of both internal growth, i.e., the retention of profits, and the infusion of new capital into the banking area. As chartering of banks is restricted by the policy of the various regulating authorities, we can assume that the desired investment of capital into non-member banks was greater than the realized investment--i.e. the 19.6% growth rate of non-member bank capital in 1970-72 is smaller than the growth would have been if entry were unregulated.

Another factor making for the relative growth of non-member banks as against member banks lies in the shift in the ownership of deposits. Whereas households owned 50.5% of the total demand deposits and currency in 1962 and non-financial corporations owned 18.0% in 1972 households owned 60.1% and corporations but 13.8%.

Households will tend to hold their deposits in convenient locations, whereas business will tend to hold deposits in the banks at which they borrow. In those states with unit-banking, the urban sprawling that has characterized the post-war period to date has been accompanied by the chartering of new banks and the growth of existing banks in the suburbs. However unit banking states are but part of the total; limited branching and state-wide branching states are a major part of the American banking scene. Nevertheless even in that part of the country where conditions are most adverse for non-member banks, the states in which state-wide branching is allowed, non-member banks have held their own.

III. Implications of the Above for Our View of Banking

The basic fact about non-member banks is that their "reserve" or "cash" items are deposits in other, typically member banks. (In exchange for these deposits the member

bank performs services for its "correspondent.") As a result of this layering the volume of reserve deposits available for non-member banks is virtually open-ended. For example, if non-member banks have 20% of the deposits and hold a 10% reserve ratio, then at most 2.5% of member bank deposits are acting as reserve deposits for non-member banks. For non-member banks to expand their deposit liabilities they need only expand the portion of member bank deposits they own. Whereas a case can be made for the proposition that the Federal Reserve can control the reserve assets available for member banks, the Federal Reserve has little or no control over the volume of "reserve" assets acquired by non-member banks.

The rapid growth of non-member banks over the past decade represents an accelerating movement towards an hierarchial banking system in which member banks hold Federal Reserve deposits as cash whereas non-member banks and other financial institutions hold member bank deposits as cash. Such an hierarchial banking system is much more unstable, in both expansions and in contractions, and is much more susceptible to crises and crashes than a simple system.

The development of non-member banking is a striking example of Simons' principle with respect to the reappearance of old usages under new forms. The crisis-prone National Banking System (prior to 1913) was an hierarchial, layered banking structure in which one class of banks kept reserves in another class of banks. Sixty years ago the Federal Reserve System was supposed to eliminate or greatly diminish the importance of this phenomenon. We are seeing the old forbidden system reappearing in a new guise.

IV. Commercial Paper Developments

At the end of 1962, open market paper (commercial paper, acceptances, etc.) totaled \$8.7 billions--at the end of 1972 such paper totaled \$48.1 billions. Of the 1962 total \$3.7 billions were owned by non-financial corporations. At the end of 1972, non-financial corporations owned \$26.2 billions of such paper; this paper is now a significant portion of non-financial corporate liquidity. (Corporations owned \$28.0 billions of demand deposits and currency in 1962, and \$36.0 billions in 1972.)

Although commercial paper originates as dated paper, the directly placed commercial paper of finance companies is often continued on a day-to-day basis beyond its stated maturity date. As a result, at any moment of time a portion of the total amount of finance company commercial paper outstanding is call debt. The convention in the commercial paper market is for the borrower to have bank lines of credit large enough to meet its debt on outstanding paper. Bank commitments to extend credit are the cash asset for commercial paper issuers. However in the financial stringency of 1970, when the volume of exceedingly short term and demand (i.e. past due) commercial paper grew very rapidly, the bank lines of credit of commercial paper issuers apparently fell short of the standard, and furthermore the banks were so far extended that they were really quite unable to meet their commitments without aid from the Federal Reserve.

The data on commercial paper shows that between January of 1969 and May of 1970 total commercial paper outstanding rose from $21.8 billions to $39.7 billions, and that at year-end 1970 the total stood at $31.8 billions. Finance company commercial paper showed a similar, though somewhat muted, roller coaster; between January 1969 and May of 1970 such paper rose from $13.9 billions to $19.3 billions, and by the end of 1970 the amount outstanding had fallen to $17.2 billions. There is no available data on the term of this paper--we have to accept informed reports that, of the total finance company paper outstanding in June of 1970, a large proportion was exceedingly short term or call debt.

V. Implications of Commercial Paper For Our View of Banking

The developments in the commercial paper market during 1969-70 is evidence that when the ability of commercial banks to finance business is constrained by monetary policy during an active, nay euphoric, period the financial system will develop ways and means of getting around the constraint. Additional evidence of this phenomenon can be found in the generalization of the Federal Funds Market earlier in the 1960's and the use of the Euro-dollar market as a source of bank reserves in the 1966 and 1969-70 episodes.

The banking system is the lender of last resort to the issuers of commercial paper. The banks that are most directly involved are the large member banks. In 1970 when a run on commercial paper took place (recall that the total outstanding fell by well nigh $8 billion in the last seven months of the year) the market situation forced the Federal Reserve either to face the risk of wholesale default or to furnish reserves in huge quantities to the member banks. The Federal Reserve correctly chose to abort the incipient crisis by furnishing reserves to member banks. This appropriate behavior may well have set some of the monetary seeds for the current inflation.

The development of the commercial paper market in the period under discussion is further evidence validating Simons' principle: once again a tendency towards an unstable layered or hierarchial banking system grew out of market developments. The very short term and demand liabilities of the finance companies function as a very close substitute for bank deposits for the holders of commercial paper. In effect organizations other than legally chartered banks create money. Such an evolutionary process which creates a new form of money in response to market forces is an additional validation of Simons' principle.

VI. General Implications.

The rapid growth of non-member banking and the explosive growth of commercial paper are evidence that money and monetary growth in the United States are endogenous economic phenomena, determined by market processes and interactions, rather than by the will and actions of the Federal Reserve. To the extent that the Federal Reserve controls the rate of growth of the reserve base, so that member banks cannot respond to financing demands, new monetary devices and usages develop which do fill the vacuum, perhaps at a higher price, and with a higher overall risk.

The major social risks that emerge from banking are two: the first is that in an euphoric entrepreneurail climate the banking process broadly conceived will act as an engine of inflation and the second is that the inverted pyramid of monetary forms that develop may become unstable in the sense that a crash will take place. The Federal Reserve acted responsibly in 1966 and in 1969-70. It is apparent that such responsible

behavior attenuates the ability of the Federal Reserve to constrain inflationary pressures.

It is too much to expect the Federal Reserve to offset the inflationary pressures that are born of a passive fiscal policy, an inability to constrain wage and profit rates in the investment goods producing industry (especially construction), and a broad policy thrust which emphasizes investment. Any advice which argues that monetary policy can do it all is either empty or is a recommendation that the country once again experience a debt-deflation process similar to that of 1929-33.

Thus monetary policy is but one, and not necessarily the most important tool of aggregate economic policy. Effective policy requires the coordination of monetary policy with other policy devices. In particular fiscal policy, in not only its aggregative but also in its allocative and distributive forms, incomes policy, which needs to be directed as much at achieving equity as it is at constraining inflation, and structural policies, designed both to make markets more responsive and to lessen the dependence of the economy on speculative debt-financed investment, are necessary dimensions to an effective policy mix.

The experience of the past decade is strong evidence that an economy with a system of borrowing and lending behaves in an essentially different way from a system without such economic relations: a system with borrowing and lending has strong internal destabilizing forces. Professor Milton Friedman's theoretical assertion "...that the central characteristic of the market technique of achieving coordiantion is fully (my emphasis) displayed in a simple exchange economy that contains neither enterprise nor money." [Capitalism and Freedom, University of Chicago Press, 1962, p. 14] is at best valid for a restricted set of problems. A monetary economy is intractably speculative, and in such an economy stability induces instability. Advice based on Friedman's postulate is simply not relevant for stabilization policy in the economy in which we live. Inasmuch as Friedman's postulate is fundamental to the doctrines known as monetarism, men with practical responsibilities, such as the Board of Governors of the Federal Reserve System,are usually well advised to ignore monetarist advice.