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Fragile financial state of nation unhealthy sign for Reaganomics

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The recent signs of financial weakness cannot be disregarded. In October 1984 a flight of offshore deposits triggered the collapse of the Continental Illinois Bank. In March the failure of a minor government bond house in Florida led to the closing of all of Ohio's state insured savings institutions and a break in the foreign exchange market that knocked some 10 percent off the international value of the dollar.

If we combine these events with the sharp decline in the price of agricultural land, the tenuous value of much of commercial real estate, the explosive increase in business debts due to corporate takeover and merger ploys, and the still unresolved problems of Latin American debts, it is clear that the margins of safety in financial relations are greatly diminished. A major domino effect collapse of financial institutions and asset values is much more likely now than at any time since the 1930s.

These financial developments together with the sputtering Reagan prosperity, which is unable to bring

We are now approaching the 2½-year mark of the current expansion. Normally we would expect the expansion to run another year or so. However, the financial structure is showing so many signs of potential disturbances and crises that the occurrence, quite soon, of a financial crisis that leads to a sharp decline in asset values, output and employment must be considered as a distinct possibility.

For investors, bankers and businessmen the downslide risks may be so great that defensive postures may be in order.

Although in our convoluted financial structure the visible repercussions of a disturbance can be far from the source, three possible, and not independent, sources of disturbances now loom large. One is in Texas banks, another is in the complex of offshore, dollar-denominated banking and a third is in the explosion of debts due to the merger, takeover and buyout mania that takes up so much of the daily press.

Oil and real estate

Although the Texas banks are

A modest orderly decline in the dollar might be welcomed by the banking authorities. However, a decline in today's markets is not likely to be modest or orderly.

A rise in interest rates to the levels of 1980-82 will play havoc with the ability of highly indebted businesses and households to fulfill their payment commitments; this will put pressure on the liquidity and solvency of already weakened banks.

The various plays which lead to mergers, takeovers and buyouts involve the use of debts—funny money, junk bonds and bank loans. For each newly highly indebted organization that results from these plays there is a maximum set of interest rates which it can tolerate. Any scenario that leads to substantially higher interest rates will see some of these deals unravelling.

No collapse seen

Given the big and still increasing government, any decline in national income will lead to a large increase in the deficit. As a result the system will not collapse as in 1929-33; but bankruptcies and the number of asset values that plunge are likely to exceed prosperity, which is ... unemployment below the 7 percent mark, raise concerns about the true nature of our economy that have not been addressed since the Great Depression.

Is our economy inherently stable? Is a close approximation to prosperity its normal state? Is it unstable? Do its internal dynamics from time to time lead to a serious depression?

These questions are addressed by the financial instability hypothesis, a variant of Keynesian economic theory which holds that over an extended period of good times profit-seeking actions of banking and businessman lead to the financial system evolving so that it becomes a hospitable enviroment for an interactive—domino effect—financial crisis.

Can be avoided

Such a crisis can usher in a serious depression, but it need not. Lender of last resort interventions by the monetary authorities and the deficits of big government during a recession can contain a financial crisis and quite quickly induce a recovery. The hypothesis also holds that inflation usually follows these market processes and government interventions.

The course of the economy during the Reagan years closely conforms to the financial instability hypothesis. The success in reducing inflation can be laid to the international strength of the dollar, high unemployment rates and the decline in union strength.

viewed as being oil related—and problems that are now surfacing in these banks may be largely due to their financing of oil exploration and equipment for such exploration—their oil losses are likely to be compounded by real estate losses. It is known that there is a sizable inventory of commercial property in the major Texas cities.

If the price of oil, the pace of oil exploration and the market value of rigs suffer another decline, then the inventory of vacant commercial property in the cities that are closely tied to the oil industry is likely to increase and its absorption rate to decrease. This will lead to the overt recognition of losses in real estate, first in the impacted cities and then throughout the economy.

Over the past years the dollar has been appreciating rapidly and there has been a large increase in dollar-denominated offshore banking. These offshore bankers have dollar assets and liabilities and maintain a position in "New York dollar assets" in order to meet clearing losses.

New York dollar assets are their reserve currency.

If the current decline in the dollar accelerates, it will be because various forms of hot money move out of the dollar and into other currencies. When this happens, these offshore dollar banks will need to sell off their New York assets to buy the other currencies.

what happened in 1981-82. The income and employment decline and the breadth and depth of the financial trauma of the next recession will likely exceed that of 1974-75 and 1981-82, even if the Federal Reserve interventions and the rise in the federal deficit take place quickly.

But if the Federal Reserve and the Treasury hold back, either because they are fighting inflation or because of their ideology and economic theory, then a second Reagan recession can become the Reagan depression.

Given the fragile financial structure and the extent to which the banking authorities are now carrying virtually insolvent institutions, there will be a crisis and a recession that exceeds what happened during 1981-82 sometime in the next several years. The only questions are when and how deep.

As recently as the winter of 1984-85 it seemed as if the expansion would carry through 1986, because the financial crunch would come later, not sooner. However events have moved quickly since the first of the year. Both participants in our economy, whose well-being depends upon prosperity being sustained, and economists, who are concerned with the validity of economic theory, will find this spring and summer very interesting.

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