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Hyman P. Minsky Ph.D.

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Synopsis:

"How to get off the Back of a Tiger"

by

Hyman P. Minsky
Professor of Economics
Washington University (St. Louis)

(A talk delivered at the National Association of Business Economists, New York, New York, June 21, 1974).

1. The policy problem that is addressed is whether the current two digit and accelerating inflation can be brought under control without first going through a financial crisis and a debt-deflation process. History indicates that a crisis followed by a debt deflation process is associated with a deep depression. Thus the question is whether we can get off the back of the inflation tiger without becoming the depression "smile" on the face of the malevolent beast.

2. Underlying the view that the choice before us is either continuing unacceptable rates of inflation and a financial crisis followed by a deep depression is the feeling that the financial structure is now fragile. In the paper, precise definitions of financial fragility are developed and data is presented that indicates that the financial structure is now considerably more fragile than early in the epoch that began at the end of World War II. A financial system is fragile when, for the various classes of units:

(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, i.e. "debt" is short term relative to "assets" so that refinancing is necessary. And

(c) the ratio of cash and readily marketable financial assets is low relative to financial assets or financial liabilities.

The data in attached Tables II, III and IV indicates that the trend since World War II has been from financial robustness to financial fragility.

3. 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:

(1) the process of being a lender of last resort means that the Federal Reserve feeds reserves into the banking system.

(2) by protecting a financial institution, instrument, or market that is under crisis type pressures, the Federal Reserve legitimizes and validates practices which in effect increases the ability of the economy to carry "debt".

4. In the mini-crisis of 1966, the Federal Reserve validated negotiable C.D.'s, 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. Thus the Federal Reserves' actions as a lender of last resort are inflationary in two ways:

(1) they feed reserves into the banking system.

(2) they 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.

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

6. One measure of the robustness/fragility of the financial structures is the ratio of cash flows 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 Reserves rescue operations not only prevent a debt deflation process but actually set the stage for a vigorous inflationary expansion.

7. 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:

(1) an emphasis upon economic growth by way of private investment.
(2) a system of government contract expenditures not only in defense and space but also in roads and housing.
(3) an emphasis on increasing transfer payments.

8. It is important to note that items (2) and (3) above (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, which tend to go along with inflationary wage increases, and which are effective lobbyists for government intervention to protect their position.

9. If the alternatives that are before us are either continuing inflation or a deep depression because of the fragility of the financial system, is there any way in which the financial system can be made more robust without going through a debt deflation and a depression? A debt-deflation followed by a depression make a fragile financial system more robust by first wiping out debt and then having a period in which the cash flows to corporations and households exceeds in the aggregate their expenditures on investment. Inasmuch as in this situation, households and firms are running financial surpluses, the government is running a deficit. However, with the current contract system, the government deficits generate profits and profit expectations, which tend

to generate speculative investments. Thus the government spending during a period in which the effort is to make the financial system more robust should not conform to the pattern it now follows.

10. What we have to do is to abandon the growth through private investment policy strategy and deliberately enter upon a period in which private investment externally financed is discouraged. 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.

11. Of course, unless something is put in their place, the reduction in expenditures on private investment, housing, and also by way of government contracts will result in large scale unemployment. I therefore propose that we replace these items by scheme of direct employment by government agencies. We should resurrect the W.P.A., C.C.C., and N.Y.A. of the depression--and maintain employment through direct government employment. As a scheme of 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.

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

13. 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 on 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 marginal 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.

14. There is incidently 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, and they constrain debt-financed expenditures until such a more robust structure is achieved. However, even as I state this alternative, I realize the futility of expecting such constraint.

[illegible]

Fixed Investment as a Ratio to Gross
Profits after Taxes
Non-Financial Corporations
1946 - 1973

Year		Year	
1946	1.53	1960	1.05
47	1.27	61	.99
48	.98	62	.94
49	.89	63	.94
50	1.07	64	.92
51	1.07	65	.97
52	1.09	66	1.02
53	1.13	67	1.05
54	1.01	68	1.13
55	.91	69	1.27
56	1.07	70	1.35
57	1.12	71	1.25
58	1.01	72	1.21
59	.94	73	1.30

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

Table II
Measures 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 1945-1 (August 1973).

Table III
Measures 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	37.6%	1.42	42.9%	32.2%
56	55.0%	2.38	63.4%	40.5%
61	66.7%	3.19	73.5%	44.9%
66	72.4%	3.94	78.7%	50.4%
71	69.8%	3.63	71.9%	39.4%
72	74.0%	3.77	72.7%	40.1%
73	79.3%	4.08	76.4%	33.1%

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

Table IV
Measures of Financial Robustness - Fragility
Commercial Banking
Selected Years 1951-1973

Year	No Default Risk Assets[1)] / Total Assets	Bought Funds[2)] / Total Liabilities
1951	54.2%	3.6%
56	43.2%	4.7%
61	36.8%	6.9%
66	24.2%	14.6%
71	20.6%	17.2%
72	19.0%	19.5%

1) Vault cash, Deposits at Federal Reserve Banks, and Government Securities

2) Large Denomination CD's, 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 (August 1973).