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Trendline, Draft, October 1975
Hyman P. Minsky

THE SKY DID NOT FALL

The past year has been a trying one for the economy. Now that data for the year running from July 1974 through June 1975 is available it is possible to reconstruct what happened. The importance of such a reconstruction lies not only in the evidence it provides as to how our economy works, but also for the leads it gives us as to what we can expect.

During the past year two related "disasters" threatened. One was the wholesale bankruptcy of banks, financial institutions, and business firms. The second was a decline of income and employment which for a while seemed to threaten a "great depression." Although there were many large scale financial difficulties - and we are still witnessing considerable financial problems, - and the recession of 1973-75 was the longest and deepest since World War II, the worse that seemed possible some six months ago did not take place. Today the economists, - these fallable seers - as they engage in their annual forecasting ritual, seem to see relatively good and tranquil times ahead.

Standard Forecast for 1976 and After

A standard forecast, that is making the rounds, is that the turn around in the economy that began in the third quarter of 1975 will continue as a mildly vigorous recovery through 1976. Thus it is forecast that real G.N.P. will increase by some 6.2% between the 4th quarters

of 1975 and 1976 and that the unemployment rate will drop to the neighborhood of 7.2% by the end of 1976 - from the present 8.3% Furthermore it is not unusual to forecast that the recovery will be aborted towards the end of 1977. Many forecasters consider another credit crunch and a severe recession in late 77/early 78 as quite likely to occur.

Our interpretation of the evidence, from the behavior of the economy in the past two years, is that the current recovery is very fragile with no strong leading private sectors. If we look at the financial relations inherited from the preceeding inflationary booms and what is happening during this recovery, the fragility is most evident. Thus we consider it quite likely that the expansion will not be as vigorous as the standard forecasts indicate, and that what we can expect in 1976 may be better characterized as a "stagnant" situation - in which the real expansion of the economy is closer to 4% than to 6%. Thus we expect the expansion to be too weak to make as substantial inroads into the unemployment rate as the standard forecast implies. In such a stagnant state the rate of capital utilization will remain low and the index of industrial production will tend to rise at about the same rate as capacity. Profit growth, though substantial, will not be as great as the standard forecast indicates and this will act as a damper on investment expansion.

The reason for holding that the recovery is likely to drift into a stagnant state is that an era of relatively conservative financial

practices by banks and corporations is likely. Over the next several years the giant money market banks have to absorb losses from their speculative engagement with the R.E.I.T.'s; financial institutions and households that own instruments such as shipping and airline debts, New York City debts, as well as debts of failing organizations such as W.T. Grant, will need to absorb the losses implicit in formal bankruptcies and debt restructuring before they will be eager to take on new "speculations." It is a significant indication of things to come that both the conservatively managed Morgan Guaranty and the more daring National City have each charged off some $35 million of losses as a result of ~~its~~ their participation in the financing of W.T. Grant.

<u>What Happened in 1973-III - 1975-II</u>

It is apparent that when the dates for the recent recession are finally set, the recession will be dated as running from October or November of 1973 to April or so of 1975; the first quarter of the recession will be the fourth quarter of 1973, the last quarter will be the first quarter of '75. Thus the recession will have lasted six quarters; which makes this the longest recession since World War II. However these six quarters of recession fall into two phases: a mild dip running four quarters from October, 1973 to October, 1974 followed by a precipitous drop that lasted six months, until April of 1975.

During the third quarter of 1974 and the first quarter of 1975 the sky really did seem to be falling. In September of 1974 industrial

production stood at 125.6 (1967 = 100). Six months later industrial production was at 110.0. Over these six months the decline was at a 26.1% annual rate. Similarly real gross national product (1958 dollars) stood at $823.1 billions in the third quarter of '74 and at $780.0 billions in the first quarter of 1975. The annual rate of decline in G.N.P. was 10.2%. Between September of 1974 and March of 1975 civilian employment fell at an annual rate of 6.7%.

If the rate of decline over the six month period (1974-IV - 1975-I) had continued for another six months the economy truly would have been a "basket case": we really would have had a big depression. But instead of continuing to decline, perhaps at a more moderate rate, the economy's decline was braked and a slight upturn began in the second quarter of 1975. Payroll employment increased in April '75 over March, '75, industrial production which was falling at a 23% annual rate in the first quarter of 1975 turned around and was increasing at a 10.6% annual rate in the three months ending August, '75, and price deflated Gross National Product shifted from an 11.4% (annual rate) decline in the first quarter of 1975 to a 1.9% (annual rate) increase in the second quarter of 1975.

Thus two sharp reversals in the path of the economy took place within a bit more than six months. First a modest recession was transformed into a sharp precipitous drop and then six months later a sharp braking of the decline and an almost immediate turn around to an expansion took place. These sudden reversals of direction show that the economy

is now much more unstable than it was earlier in the post-war era. With instability goes uncertainty, and an economy that can change its directions so sharply is one whose future is more difficult to chart than an economy in which the dominance of momentum means that it takes time to change course. Such uncertainty in and of itself is a damper on economic activity, especially in long-lifed investment.

The Impact of Government Policy

The major cause of the halt to the sharp decline and the reversal to expansion that occurred after the first quarter of 1975, lies in the massive government deficit spending that took place. The government deficit was at a $1.9 billion annual rate in the third quarter of 1974. This increased to a $24.5 billion annual rate in the fourth quarter of 1974, rose again to a $54.4 billion annual rate in the first quarter of 1975, and exploded to a $104.6 billion dollar annual rate in the second quarter of 1975. This exploding government deficit took the form of a sharp decline in income tax collections, due to the tax cut and rebate, (the annual rate personal income tax fell from $136.2 billions in 1975-I to $99.1 billions in 1975-II) and a marked increase in Federal government transfer payments (transfer payments rose from a $138.5 billion annual rate in 1975-I to a $149.9 billion annual rate in 1975-II. In the year between 1974-II and 1975-II transfer payments rose by 32%).

Because of these fiscal actions disposable personal income rose by

6.2% in the second quarter of 1975 over the first quarter of 1975 even as the unemployment rate increased. As a result of the rise in disposable income personal consumption expenditures rose by 2.8% The reversal of the steep decline in income took place because the Federal government "threw money", with abandon, at the problem. The ability of government spending and tax cuts to halt a precipitous decline in the economy was conclusively demonstrated in this recession. The issue is not the ability of prodigious government deficit spending to halt a recession - the issue is the side and after effects of such spending - in particular the issue centers around the inflationary after effects of the adopted policy mix.

As a result of the explosive growth of transfer payments over recent years, in the second quarter of 1975 government transfer payments were 16.1% of disposable personal income. That is well nigh one out of every six dollars that households had to spend or had spent for them on consumption was a result of a federal or state program which granted this income independently of current work. As a particular case in point unemployment insurance, which was at a $6.3 billion annual rate in the second quarter of 1974, rose to a $19.4 annual rate by the second quarter of 1975. Such a dramatic rise in unemployment insurance payments is part of the explanation of why the sharp downturn was turned around so quickly. On the other hand high and lengthy unemployment benefits are inflationary both during the downturn and in the subsequent

recovery.

What we can say is that the sudden reversal of the economy in the second quarter of 1975 and the recovery that has continued to date is the result of the massive government programs of tax rebate, tax reduction, and transfer payment expansion. If you throw enough money at a recession you will halt the recession. However this money throwing technique to combat recessions has side effects, such as the continuation of inflation during the recession (any increase in the proportion of transfer payments to income is inflationary) and the setting of the stage for accelerating inflation once an expansion takes place. Furthermore each improvement in transfer payment schemes has the effect of raising the price at which some people will enter the labor market. Thus the real productive capacity of the economy is eroded when transfer payment schemes are improved, especially if, as is our practice, eligibility for receipt of transfer payments depends upon not being in the labor force. Certainly in order to do better we need thoroughgoing reform of our transfer payment schemes.

Financial Developments

In the last quarter of 1974 and the first quarter of 1975 it seemed as if the revealed financial difficulties of banks, financial institutions, major corporations, and municipalities might very well lead to major financial dislocations, which in turn would feed back to cause a continuation of the sharp decline. We are not yet out of these

woods. The continued perils of New York City, the bankruptcy of W.T. Grant & Co., and the warnings by debt holders to airlines are evidence that further financial trauma might well occur. If such trauma do occur, they might very well lead to another "dip" in the economy - more than likely in the first or second quarter of 1976. The response of the economy to further financial trauma will depend upon the actions taken by the Federal Reserve and the Government. Given the disarray and confusion in the Administration and Congress, it is quite impossible to predict the response to threats of financial disarray if such threats become imminent.

The financial events of the first two quarters of 1975 were dominated by three phenomena: a massive government deficit, which meant an infusion of government debt into the portfolios of banks and other private units; a run off of inventories by corporations, which enabled corporations to repay debt; and a high savings rate by households, that implied an increase in household holdings of liquid assets. The infusion of government debt, corporate inventory liquidation, and the high savings ratio of households all mean that the overall financial picture was becoming more robust.

However by historical standards the corporate, households, and financial institution balance sheets (let alone the balance sheets of municipal bodies) were very fragile at the end of 1974. The changes that have taken place have only improved the situation a bit.

For the important corporate sector the inventory run off in the first two quarters of 1975 resulted in a reduction of the dependence upon external finance: in fact in the second quarter of 1975 gross internal funds exceeded total corporate investment by a $10.0 billion (annual rate) margin. This means that corporations on a net basis were able to repay debt. If we take into consideration the funds non-financial corporations raised in the equity market, $9.7 billions (annual rate) and by long term bonds, $36.3 billions (annual rate) during 1975-II it becomes evident that the overall improvement in corporate liquidity was proceeding at a significant dip during the period of massive government deficits.

Simultaneously with this improvement in corporate liquidity, the effects of the tax rebate, tax reductions, and transfer payments were to increase household disposable income. This led to a rise in the household saving rate to the very high 10.6% rate in 1975-II. This high household saving rate meant that household liquidity was being improved - and this had its mirror image in the flow of funds to time and savings institutions. This in turn improved the liquidity of these institutions so that is seemed as if funds would quite soon be available for the financing of housing.

However if we look a bit more closely at the corporate financial picture the improvement in corporate financial relations was mainly due to the inventory liquidation that occurred at a $30.5 billion dollar (annual rate) in the second quarter of 1975. If we look at the basic

internal funds - fixed investment relation, in the second quarter of 1975, fixed investment remained at 123% of internal funds. Corporations were still running a basic deficit even as the government was running a deficit. Given the situation in 1975-II it is evident that as soon as inventory liquidation ceases and inventory accumulation begins - and there are basic changes that happen in a private sector based recovery - corporations will once again require massive external financing. Inasmuch as the absorptive capacity of the bond market is being strained at the present pace of external financing, any continuation of the expansion that is based upon private financing will require large scale increases in corporate short term debt. Thus the availability and the terms for such short term borrowing are the key determinants of the future of this recovery.