Bard

Bard College
Bard Digital Commons

Hyman P. Minsky Archive | Levy Economics Institute of Bard College

9-25-1974

The Futility of President Ford's Economic Summit

Hyman P. Minsky Ph.D.

Follow this and additional works at: http://digitalcommons.bard.edu/hm_archive

Recommended Citation
Minsky, Hyman P. Ph.D., "The Futility of President Ford's Economic Summit" (1974). *Hyman P. Minsky Archive.* Paper 214.
http://digitalcommons.bard.edu/hm_archive/214

This Open Access is brought to you for free and open access by the Levy Economics Institute of Bard College at Bard Digital Commons. It has been accepted for inclusion in Hyman P. Minsky Archive by an authorized administrator of Bard Digital Commons. For more information, please contact digitalcommons@bard.edu.

Bard

The Futility of President Ford's Economic Summit

by

Hyman P. Minsky
Professor of Economics
Washington University

(A talk at the Washington University Assembly, September 25, 1974)

The Futility of President Ford's Economic Summit

by

Hyman P. Minsky
Professor of Economics
Washington University

(A talk at the Washington University Assembly, September 25,1974)

President Ford said "We are all soldiers in a war against a brutal inflation." I venture to say that Ford's war will be as successful as the Johnson war on poverty and the Kennedy-Johnson-Nixon war in Vietnam.

The economic summit is not a serious effort to come to grips with our current crisis. The two-digit and still accelerating inflation is but one dimension of the crisis. Other dimensions are a fragile financial system, sharp declines in some components of output, and unsatisfactory, and still increasing, unemployment rates.

The summit is a frivolous exercise in political showboating. It is futile, because it is seeking simple remedies for complex problems that reflect deep-rooted structural characteristics of our economy and our public policies. To put our house in order we need fundamental changes in the economy and of economic policy.

The summit is futile because of its composition. Many of the participants represent narrow special interests. At the various pre-summit sessions the special interests took predictable lines, urging anti-inflation policies favorable to their particular interests.

The summit also includes academic economists. The press reported that liberals, conservatives and Galbraith participated. But in truth the academic economists, including Galbraith, were almost entirely drawn from a very small set: they had served as house intellectuals for Kennedy, Johnson, or Nixon. Although some participants are quite young, the ideas of the academic economists who participated make them yesterday's men and women. As the underlying policy errors that brought us to our present crisis go back to Kennedy's day or earlier, the summit is a gathering at which the architects of the crisis are supposed to come up with a cure for the crisis.

The summit is also futile because we know that the administration will prescribe further doses of old fashioned religion--which consists of constraint on monetary growth and a budget surplus achieved by cutting spending. More than likely a shopping list of private investments deemed necessary for economic growth will be presented and totaled, and the predictable conclusion will be that we have to adopt programs that look to an increase in savings. We may even be told that in the war against inflation sacrifices are necessary. In the context of the assumed need to increase savings, this can only mean a systematic program to take from the poor--and this includes employed factory hands--and give to the rich.

This standard program will not work. The current accelerating inflation with rising unemployment and decreasing, or constant, gross national product in the context of fragile finance is mainly the result of structural characteristics of our economy. The standard monetary and fiscal policies that make up the old fashioned religion assume that there is nothing basically wrong with our form of capitalism. To standard economists the current crisis is almost entirely the result of past policy errors, either by the Federal Reserve in controlling the money supply or by the Federal Government in spending and taxing, i.e., the errors are in monetary and fiscal policy. In truth the current crisis reflects flaws that are inherent in a capitalist economy with a complex and sophisticated financial structure.

Before going into the body of my talk, I will comment on a question which is very much in the "news"--"Will we have a Great Depression like the 1930's?" I don't believe we will. First of all we do know how to offset a depression--although the way we do this leads to a continuation of inflation. Secondly there is a great deal of room between the worst recession we have experienced in the years since the second World War and the Great Depression of the 1930's. I believe we are now in the most serious period of readjustment since the second World War, and we now may be well into the most serious recession of the post World War II era.

My basic message is that the economic organizations and the technique for managing economic policy that evolved during the Great Depression and the immediate post-war years have run out of steam. We need a new age of reform that looks toward a rather basic restructuring of our economy.

In an economy like our's the Federal Reserve can control the money supply only if the financial system is robust. A financial system is robust when banks, other financial institutions, households and corporations have a small amount of debt relative to their incomes and to their secure financial assets. At the end of World War II the financial system was robust. Since that time the speculative activity of businessmen and bankers has transformed that robust financial system into one that is fragile. In a fragile financial system, an effort by the Federal Reserve to constrain demand by decreasing the rate of growth of the money supply (i.e. the policy that has been followed the past year) will threaten the solvency and liquidity of many units, especially financial institutions such as banks, savings institutions, and real estate investment trusts, and disrupt the normal functioning of financial markets such as the Stock Market and that for commercial paper. This threat of a financial crisis occurs before monetary constraint leads to a significant decline in the demands that generate inflationary pressure. Standard economic theory does not make the distinction between fragile and robust financial systems, and thus does not allow for a threatened financial crisis to occur as a result of policy actions before the desired price and demand changes.

However, the Federal Reserve is well aware that financial crises have been the triggering events for great depressions, and that the Federal Reserve's primary responsibility is to act as a lender of last resort. Thus, it intervenes to abort any incipient financial crisis.

The credit crunch of 1966 and the Penn-Central crisis of 1970 were just such incipient financial crises. The Federal Reserve prevented them from developing into full-fledged crises. But what the Federal Reserve does to abort a crisis leads to an acceleration of inflation--and what it does to halt an inflation tends to induce,

in the context of a fragile financial system, a financial crisis. Thus we are faced with a dismal cycle of monetary constraint, an incipient financial crisis, a pause in the economy, and then an acceleration of inflation. In our current economic circumstances it is best to view Federal Reserve action and thus the money supply as a result, rather than as the cause, of economic developments.

In order to get out of this dismal inflationary cycle we have to make our financial system more robust. The financial system went from being fragile to being robust during the serious depressions of history. One aspect of a financial system's robustness is the percentage of no risk assets in the system: in today's world no risk assets are largely government debt. If we have a government surplus and full employment then the risky debts of banks, corporations, and households increase relative to their safe assets. The standard fiscal policy advice of generating a surplus as an anti-inflationary device will make the financial system more fragile.

Of course we can abandon full employment. But any substantial decline in household wage income and corporate gross profits after taxes will make debt income ratios even higher. This, too, will increase the fragility of the financial system.

In order to make our present financial system robust without going through the blood bath of a serious depression we need a period in which (1) the Federal government runs a deficit, (2) private business spends less than its retained earnings on investments, (3) households spend less than their disposable income and (4) full employment and corporate profits are sustained. This is quite a package.

However, it can be achieved by a proper combination of taxes on private investment, especially externally financed investment, downpayment and term regulations on household installment credit, and a government spending program that resurrects the W.P.A., C.C.C., and N.Y.A. of depression days.

Thus, in the current fragile financial environment we cannot look to the textbook anti-inflationary measures for a solution. The real world situation--which includes this sophisticated financial system which is now fragile--is inherently

unstable. Capitalism, as it has developed in the United States over the 40 years since the great depression, is now more an engine of inflation than a vehicle for progress.

This is so because much of our economic policy as well as the organization of the business sector reflects the situation that ruled in the Great Depression and earlier, when government neither accepted the responsibility nor had the capacity to prevent depressions. We need a new age of reform that will modify our basic economic structure and set of policies in the light of the demonstrated power of economic policy to prevent depressions and sustain employment.

As I see it there are five somewhat overlapping flaws in our economy and our policy thrust, aside from the inherent instability due to finance, that need to be remedied if we are to make full employment more compatable with reasonable price stability and sustained financial robustness. These flaws are:

(1) The emphasis upon growth through investment.

(2) The lack of adequate controls upon the liability structure of banks, other financial institutions, and corporations.

(3) The emphasis in government spending upon contracts to private business.

(4) The validation of private wages and costs either through government spending or through the prices of regulated industries.

(5) The design, as well as the excesses of transfer payment schemes: i.e., Social Security, government pensions and welfare.

I will take these up in order.

(1) Economic Growth

Economic growth became a major objective of public policy during the Kennedy years. The theory, which guided policy, was that to accelerate economic growth it is necessary to increase private investment. But to induce more investment it is necessary to raise the price of consumption output relative to wages, so that income is shifted fron wage earners to profit earners, from those who consume income to those who save. Thus, what is done to increase the rate of investment is socially perverse in two ways.

It tends to increase prices relative to costs--it is inflationary--and to shift income from the poor to the well-off--it increases inequality.

The emphasis upon, and commitment to, perpetual growth means that investment in capital intensive industries, where it takes a long time to build plants, is based upon what is expected to be needed some five to ten years in the future. This is especially true in the energy industries. It takes some seven to ten years to build a nuclear power plant--and then they may not work (some 40% of all the nuclear power plants in the United States are now under orders to shut down within sixty days for an emergency inspection). But, at a 7% per year growth in electric energy consumption, the amount of electricity that will be used in 10 years time (1984) is twice the amount being used today. Furthermore, nuclear power plants are much more intensive with respect to capital requirements than fossil fuel plants. Thus the capital requirements for nucleation of electric energy production are enormous.

However, if electric energy consumption were to grow at a modest 2% per year, then we would not need to double capacity until 35 years from now (2009).

There is nothing sacred about a 7% rate of growth in electric energy consumption. I venture to assert that if the construction of electric energy capacity were based upon a modest two percent growth per year, an enormous amount of the inflationary pressures we now have would disappear.

Economic growth is necessary for India; it is not necessary for the United States. In 1973, at current prices, the average per capita consumption expenditure in the United States was $3,826. What is wrong in the United States is the distribution of this sum. As a rule of thumb, and this is a crude approximation, the top 5% of our population does 20% of the consumption while the bottom 20% of our population does 5% of the total consumption. This means a representative family of four in the top 5% spent over sixty thousand dollars a year on consumption, whereas a representative family of four in the bottom 20% spent less than four thousand dollars a year.

It is obviously of little social importance to arrange things so that 23 years from now the representative family of four in the top 5% of our population can spend

over $120 thousand dollars in 1973 prices on consumption, which is what a 3% growth rate implies. When it comes to growth we have to ask "How much is enough?"--i.e., whether the better use and distribution of what we now can produce is not now preferable to the disruptive inflationary and distributive effects of seeking accelerated growth. We need to ask whether the labor and the skills that would go into the proliferation of nuclear power plants could not better be used in educating youngsters, or in making our cities better places to live.

Similarly we have to get over the idea that there is a housing shortage in the United States which requires the building of in excess of two million units a year. One has only to look at the abandonment of housing in our cities to realize that we have a housing surplus, especially if the quality of life in the central cities is improved. Some of the labor now used for new construction can be better used to maintain existing structures--the rest can be redeployed to other uses.

One further point about growth: if the United States were to adopt various measures--aimed at stabilizing per capita energy consumption, such as punitive excise taxes on car weight, a substantial excise tax on gasoline, and electric utility tariffs which increase rates as consumption increases--within a matter of months the Oil Cartel would break, and world oil prices would be tumbling down toward the levels that ruled several years ago.

(2) Financial Reforms.

The evolution of the financial system from being robust to being fragile means that the power of monetary and fiscal policy to control the economy is much attenuated. The elaboration of the complexity in the financial structure is one way in which inflationary demand is financed even in the face of monetary constraint. As was pointed out earlier, once the financial system is fragile the threat of financial instability makes the Federal Reserve more an accomplice to inflation than an independent controlling influence upon the economy.

One objective of financial reforms should be to sustain a robust financial system. Liability structures of corporations and the asset-liability mix of banks should be

limited. One element of fragility in the present financial position is the extremely extended position of the very largest American banks, especially those with large overseas branches: financial controls should limit the asset equity ratio of banks. A typical desired ratio would be on the order of fifteen to one; at present some of the very largest banks have a ratio of more than thirty to one.

In the present circumstances the giant commercial banks, as well as in the financial condition of many utilities, airlines, and financial organizations such as R.E.I.T.'s, may soon need some substantial infusions of capital. I suggest that the Reconstruction Finance Corporation of the Great Depression be revived on a standby basis. If it once again becomes necessary to infuse capital into the giant banks and corporations the government should retain a permanent ownership interest in the organizations it bails out.

(3) Contracts versus Jobs

During the Great Depression the emphasis was upon jobs. The government created jobs by employing the unemployed directly in the Works Projects Administration, and the Civilian Conservation Corps. The National Youth Administration created jobs for youth both in and out of school.

At the same time as W.P.A., C.C.C. and N.Y.A. were directly creating jobs, the Roosevelt administration also funded, under the Public Works Administration, construction projects which used private contractors. During World War II private firms were used to produce the weapons of war.

After World War II the government employment-oriented projects were not revived, but the contract system of government expenditure for roads, housing, hospitals, military, and space remained. As a result of the contract system, the private contractor's agreements as to costa and prices become the basis for government expenditures. The government has abdicated control over its spending as long as it does not sit in on the negotiations that determine wages and costs for the various contractors from whom it buys.

~~The government~~ contract system is heavily involved in construction expenditures. In 1950, shortly after the end of World War II, the ratio of average gross weekly earnings in contract construction to average gross weekly earnings in manufacturing was 1.19; in 1960 this ratio was 1.26; and last year (1973) this ratio was 1.45. This changing ratio is one of the explanations of the urban crisis.

Contract construction is a large component of investment expenditures. Investment is made in the expectations that gross profits after taxes from investment will be sufficiently high to leave a margin of safety over the payments required by the debt instruments used to finance investment. When construction wages go up by 26%, as they did between 1967 and 1970, it forecasts a need to raise dollar markups over labor and material costs in those firms that use the more expensive plant. With a lag, construction wages will be reflected in the price level of output. Firms will not use or buy the more expensive capital assets unless they expect to increase profits. Construction wage increases in the Vietnam War era were significantly higher than in earlier periods. I impute the inflation of recent years in good measure to the rise in the price of investment output and the insistence upon maintaining relatively full employment through private investment. To make investment produced by labor with these rapidly rising wages profitable, it is necessary to balloon prices throughout the economy up to a price level that reflects labor costs in the production of capital assets.

(4) Validating Private Decisions

Last week the Wall Street Journal carried a story that Delta Airlines signed a new contract with its pilots, which will give its senior pilots an income of about $100,000 a year--this for an eighty-hour month. Apparently Delta is profitable and can afford this. However, Braniff is not as profitable, and if it meets the Delta pilot wages it will not make the target rate of return (12%) which the airlines are supposed to earn. In these circumstances the regulatory agencies will raise airline fares.

Now, whatever the airlines may be, they do not conform to the competitive industry of the economics textbook. In truth, their rates are much like private taxes imposed on users. These taxes are designed to enable the airline to fulfill its financial commitments.

It seems incomprehensible that the rate-setting authority does not have a voice in setting the wage of pilots, mechanics, and executives in the airlines. Pan American is asking for a subsidy. How much of the subsidy will go to pay the $100,000 a year pilots and the $250,00 a year executives is never asked by the subsidy-giver.

Similarly, when Medicare was introduced, the paying agency did not effectively bargain with doctors on the fees to be charged; rather the government allowed private medical practitioners to set the prices they were charging --and the government paid.

Similar arguments can be made with respect to the electric industry--except in this case the rate structure is not only a tax system but also a most regressive tax system. Note that the errors involved in nuclear power plants are paid for by the users of electricity--not the managers or owners of the facilities. Tight cost control by buyers, and sharp bargaining by purchasers, are not induced by the technique by which rates are set. The validation of private contracts through private taxes is a way to assure inefficiency.

It is clear to me that for at least those wages and salaries that are derived from government spending and government regulated industries, the government should take part in the bargaining process. This implies that selective wage and price controls will rule,on a permanent basis, for regulated industries and those organizations and industries which directly sell a large proportion of their output to government. If the government pays or regulates, it should sit at the bargaining table.

If an industry of importance to the production of total output is so organized that a firm, or a small set of firms,has significant ability to determine output, then the alternatives are either to break the firm up--or to allow it to continue in the present form but to make its wages and prices conform to a national standard laid down for workers employed by monopolistic and regulated industries.

(5) Transfer Payments

In 1950, government transfer payments to persons were $14.3 billion--this was some 6.8% of disposable personal income. In 1970, transfer payments were $75.1 billion; some 10.9% of disposable personal income. In 1973, disposable personal income was

$882.6 billion and transfer payments were $112.5 billion; more than 1/8th of disposable income can be imputed to Social Security, welfare, veterans' benefits, etc.

Transfer schemes are transfers of income from the economically active members of the population to the economically inactive. From being very modest programs to begin with, they have now become a more than two-digit proportion of disposable income. The time has come for a serious reconsideration of these programs.

These programs, as they are now structured, are creatures of the Depression, during which an enormous proportion of the labor force was unemployed. One way to decrease unemployment is to get people out of the labor force. This was written into the Social Security Act--as well as into the Aid to Dependent Children welfare schemes. The time has come to put a halt to this nonsense--especially as in an urban society there is a multitude of jobs that are best handled by part-time workers. Instead of forcing people to retire at 65 to obtain their Social Security, they should be allowed, nay, encouraged, to continue working, using their wages to supplement Social Security benefits. Between 1969 and 1973 government transfer payments increased from 61.9 to 112.5 billions, an increase of 82%. To my mind this is a more significant contribution to our current inflation than the rate of increase of the money supply.

Incidentally, with respect to the much abused welfare situation--I would replace Aid to Dependent Children with a universal but modest children's allowance--and simultaneously remove the tax allowance for dependents. We now have a children's allowance that increases with family income--in the scheme I advocate, it would decrease with family income and would be negative for high income families.

What I have "thrown into the pot" are some perspectives that should enter into a program of reform designed not only to make our economy less susceptible to both accelerating inflation and deep depressions but which are also aimed at making the economy better serve the goals of economic efficiency, social justice and individual liberty. Without reforms that strike at the roots, in the rigged market system, of the instability, inflation, inefficiency, and inequality that exists, the prospects are that we will have further rounds of the dismal inflation-crisis-stagnation-accelerating inflation cycle.

The summit, being a variety of show business, cannot develop a serious and legitimate program of reform that not only tackles our current crisis but looks beyond that to a restructuring and redirection of our economy: whatever comes out of the summit cannot be legitimate.

In the Senate's Watergate Hearings and in the work of the House Judiciary Committee which led to Mr. Nixon's resignation, we saw how public opinion which legitimizes meaningful change is brought.

After this futile summit is over, I urge the Congress to be serious and establish a Special Committee on the American Economy that will put together a forward-looking staff of professional economists, who are not committed to validating yesterday. This Committee should issue reports and hold hearings. The objective of the Committee should be to propose a comprehensive package which looks toward restructuring our economy and reforming public policy so that the economic machinery will better serve the needs of the people. Only the Congress can confer legitimacy on the basic reforms that are needed if we are to do more than paper over the inflation, instability, inequality and inefficiency that is the cross we all now bear.