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Op-Ed Piece

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When Ford became President the stock market reflected apprehension about the economy rather than elation that Watergate was over. This apprehension is warranted, as there is a greater likelihood of a serious financial crisis now than at any time since the 1930's.

Conventional wisdom has it that a financial collapse and deep depression cannot happen again because the Federal Reserve and the Government will not let "It" happen. However, in today's financial environment the authorities are not that powerful: what they do to slow inflation is likely to trigger a financial crisis, and what they do to abort a crisis and offset unemployment tends to accelerate inflation. Orthodox monetary and fiscal policies cannot deliver full employment without inflation.

The standard rules for monetary and fiscal policy are derived from an economic theory which virtually ignores financial factors as determinants of the behavior of <u>an</u> economy. In fact <u>our</u> economy is intensely financial. A complex structure of borrowing and lending, based upon various margins of safety, exists: these margins consist of the net worth, holdings of liquid assets, and expected excess of cash receipts over cash payments of borrowers. The acceptable safety margins are determined by borrowers and lenders views of the future. Being subjective, these views change in response to experience.

When World War II ended private debt was very small, corporations, households, and banks held large amounts of safe government debt, and bank liabilities were mainly demand and pass-book savings deposits. The financial system was robust.

Today the financial system is fragile. Household and corporate debt are high relative to income and holdings of liquid assets. Banks hold

minute amounts of government debt and they manage complex, speculative liability and asset structures.

The margins of safety have decreased markly over the post-war period. When safety margins are thin the financial system is unstable: one failure can lead to many failures. A wave of failures, especially among financial institutions, constitutes a financial crisis. After a crisis, both borrowers and lenders desire increased margins of safety.

The deep depressions of history followed financial crises. During deep depressions debts are liquidated, the financial system becomes more robust. A fundamental characteristic of our economy is that the financial system swings between robustness and fragility and that these swings are an integral part of the process which generates business cycles.

During good times, when only mild recessions occur, business men and bankers agree that the inherited safety margins are too large, and that more debt should be used to finance investment and the ownership of assets. The increased debt-financing of investment both sustains the good times and makes the initially robust financial system increasingly fragile.

The credit crunch of 1966 and the Penn-Central crisis of 1970 signalled that the financial system was again sufficiently fragile so that a financial crisis could occur. In both 1966 and 1970 the Federal Reserve promptly intervened by pumping reserves into the banking system, thereby preventing a full scale financial crisis. Even so a slow down occurred, which led to substantial deficits. Thus policy, while successfully preventing a debt-deflation and deep depression, set the stage for accelerating inflation.

The 1966 and 1970 ~~crises~~ episodes involved fringe financial institutions. In the current situation the viability of some giant multi-national banks is questionable. The liabilities of these banks are mainly bought, and therefore potentially hot, money. Furthermore, in part because of oil money, the equity-liability ratios of the giant banks are paper thin.

If a financial crisis threatens these institutions, the monetary and fiscal interventions that will be needed to abort the incipient financial crisis and to sustain employment will be so large as to assure an acceleration of inflation.

Because of the fragility of the financial system we are trapped in a dismal cycle of inflation, crisis, and accelerating inflation. To escape we need a more robust financial system. This can be achieved if, for a time, corporate investment is smaller than gross profits after taxes and household debt financial spending is reduced. Thus measures designed to increase private investment, such as the investment tax credit, must be repealed. Furthermore, constraints, such as down-payment and term limits, should be placed upon consumer debt.

As these measures will reduce private spending and increase unemployment, equity requires that a program of public service employment be part of the anti-inflationary policy.

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