

OUR FINANCIAL HERITAGE AND THE PROSPECTS FOR '76

Prepared remarks for the
23rd Annual Conference on the
Economic Outlook
December 12, 1975

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We are now in a recovery which apparently will not make it to reasonably full employment. The forecasts we have heard is that 1976 will be a year of relative tranquility; moderate expansion, and moderating inflation. In the light of both recent experience - the financial instability evident since 1965 and the trials and tribulations of 1974-75 - and our long national heritage of financial troubles - the forecast of tranquility is suspect. There are financial time-bombs that could make 1976 as volatile as any of the past several years furthermore the process of successfully defusing financial time-bombs can set the stage for subsequent inflationary bursts. Rather than view the economy as tending towards a growth equilibrium, as forecasting models do, it might be best if we view our economy as a tight rope walker: On one side it can "fall" into accelerating inflation, on the other it can "fall" into a deep depression.

Even if we avoid financial trauma in '76, recent experience and the unfavorable balance sheet relations, that are a heritage of the past several decades, indicate that an era of financial conservatism by corporations and bankers is in the offing. This, by itself, will make the recovery weak. Thus I look for sluggishness through 1976, with a proviso that if some of the financial time-bombs go off, a resumption of the sharp decline of 1974III and 1975I will ensue.

To appreciate the limitations of the forecasts we need to appreciate the limitations of the economic theory embodied in

forecasting models. This standard theory is suspect on two grounds. It has serious logical flaws it really is unable to handle capital assets and money/finance, and it is not able to explain the instability that has characterized our economy. In standard theory - and in the usual forecasting models - there is a built-in tendency for the economy to move towards a growth equilibrium.

In particular standard theory and thus the forecasting models are weak on the interactions of finance with income, employment, and prices. In standard theory and the usual forecasting models finance is encompassed by "money", the supply of which is presumably controlled by the Federal Reserve. In these models money supply affects interest rates which in turn affect investment; housing investment most directly. The influence of finance is more pervasive than this narrow focus admits - and finance introduces strong disequilibrating forces in our economy, so that normal behavior is cyclical rather than steady growth.

The basic financial relations in our economy center around the acceptable liability structure for the ownership of various types of assets: i.e. how much and what kind of debt is used. Money in our economy is a type of bond, the supply of money emerges out of financing decisions; money is not just some generalized ration point. Acceptable debt structures vary with perceptions of risk: bankers and businessmen usually perceive risk by extrapolating the past. The relative success of the first fifteen or so post-war years led to views that accepted

ever greater private debt, whereas a calamity, such as occurred in 1929-33, breeds views that abhor debt.

Hedge financing exists when in each period the unit receives sufficient cash from operations to meet its financial commitments. Speculative financing exists when in the near term the unit does not expect to receive sufficient cash to meet its commitments, although the capitalized value of expected receipts exceeds that of expected payments: i.e. receipts are longer than payments. Speculative financing units have to borrow to pay debt, hedge units do not. Thus speculative financing units are, and hedge financing units are not, vulnerable to high and rising interest rates. The proportion of speculative to hedge financing increased over the years since World War II and this made financial markets and financing interrelations increasingly fragile: i.e. susceptible to financial disturbances. When the financial structure is sufficiently fragile, financial crises and debt deflation processes - such as occurred in 1929-33 - can and do take place.

The increased fragility of the financial system made the credit crunch of 1966, the liquidity squeeze of 1970, and the spate of financial difficulties in 1974-75 possible. In 1966 and 1970 Federal Reserve action combined with the financial and income sustaining effects of big government aborted the threatened financial crisis and held the line against a possible debt-deflation. However it is worth noting that after the 1966 crunch and the 1970 squeeze the pace of inflation accelerated. Inflation is the price paid for successfully aborting a threatening financial crisis.

The trends exhibited in Tables I and II, especially since the mid-1960's, of various income and balance sheet ratios are evidence that the financial system became increasingly fragile.

The financial difficulties of 1973-75 were more pervasive than those of 1966 and 1970: three banks in the billion dollar class failed, an entire financial industry, the REIT's, is being cut back if not liquidated, giant banks are taking unprecedented loan losses, financial problems of major corporations are a matter of public record, and our largest city is on the verge of bankruptcy. In each case the cash needed to validate debt has not been forthcoming from normal sources. Problems arose because of the volume of short term debt and higher interest rates, which raised the cost of prior speculative postures.

As is clear in Table III, 1970-73 saw an explosion in the funds raised in financial markets by households and corporate business. These growth rates exceeded the growth rate of either household disposable income or of corporate internal funds: Thus the ratio of debt to funds available to service debt rose.

Funds raised by households fell sharply in 1974. No further fall of such funds took place in 1975I-1975III. In 1974 corporations raised more funds than in 1973, however in 1975I-1975III corporate borrowing fell sharply. In part the drop in funds raised by the corporate sector reflects the liquidation of inventories, but it also reflects a sharp decline in the ratio of fixed investment to internal funds.

The government deficits led to the screeching halt to the decline and the sharp increase in Gross National Product that occurred in 1975. It is evident that a government deficit of \$70 billion over a four quarter period has an enormous expansionary effect.

There are three expansionary effects of a government deficit. One is the direct effect of throwing money at households and flinging orders at business. Second is an indirect effect, secure financial assets in the form of government debt are forced into the portfolios of households, business, banks and other financial institutions. The \$70.0 billions raised by the Government between 1974IV and 1975III had to show up as safe and secure assets in portfolios, which cushion the effect of weakened private assets. Third is also an indirect effect: government deficits will be offset by surpluses or smaller deficits by the household and business sectors. The induced profit flows to corporations during 1975 sustained and increased their ability to service debts.

The recovery rests on big government. An attempt to reduce government deficits before the private financial system is robust will soon lead to a resumption of the decline and increase the likelihood that the financial time-bombs will detonate.

As established historical pattern (Table I) is that a rise in the ratio of corporate fixed investment to gross internal funds takes place in good times, especially over extended good times, and a decline in this ratio, even unto negative values, occurs in recessions and periods of sluggish economic performance. In

Table IV the ratio of fixed investment to internal funds in 1975I-1975III can be compared to 1974I-1974III. One quarter does not make a trend, but the evidence indicates that when the ratio of fixed investment falls to or below 1, as it did in 1975III, it does not quickly return to the high levels of the early 1970's. We can expect several quarters, and perhaps several years, to pass before we see a resumption of debt financed investment.

Corporate gross internal funds increased sharply during 1975. The virtual balance between fixed investment and gross internal funds resulted from internal funds rising, not from nominal fixed investment falling. This rise in corporate funds is an offset to the exploding government deficit.

As a result of the burdens that debt financing imposed in 1975 and is continuing to impose upon many financial institutions and corporations, lenders will likely be reluctant to debt-finance fixed investment, even as income recovers. Corporate internal funds will be a closer governor of investment in the next period than was true in the 1970's to date.

As we look towards 1976 we recognize that January 1 will not see the vanishing of the giant banks, REIT's, airlines, oil tankers, and New York City "time-bombs". The recovery is vulnerable to a disturbance from financial markets. A failure of one of the walking bankrupts or public difficulties for a giant bank can induce even more conservative behavior with respect to debt than was experienced in 1975III.

One vulnerability follows from the exposure of our largest banks to possible flights of their overseas deposits. In the 1970's foreign branching was taken as the "new frontier" for bank profits. This opening was exploited. Some of the largest banks now have a major proportion of their liabilities in overseas deposits. Such overseas deposits can become a 1970's version of hot money - seeking safety by jumping from one set of banks to another. There are indications that American overseas branches experienced run-offs of deposits in November, as New York teetered on the brink of default. In my view Ford backed down from his hard line, in part, because of the dangers to the overseas American banking community of a default by New York.

The tranquility and moderation forecast for 1976 is therefore suspect. The apple cart can be upset by an exposure of financial weaknesses, a spectacular bankruptcy, a premature attempt to bring government expenses in line with revenues, or a rise in interest rates. The odds are good that one or more of these will take place.

In particular given the expected weak performance of business investment relative to internal funds, if the three way prop of government deficits is removed, the decline in income soon will be resumed. Such a decline, and in particular the decline in corporate internal funds that will ensue, will make it more likely that some of the "time-bombs" planted in our debt structure will detonate. We are hooked on big government with a very inefficient spending program.

To some extent the level of interest rates is determined by Federal Reserve actions. If the Federal Reserve initiates or acquiesces to sharp rises in interest rates, cost pressures on units engaged in speculative finance can also trigger financial difficulties.

Thus the time-bombs in our financial structure can go off on their own, or they can be triggered by policy errors: '76 can be a year of turmoil rather than of tranquility.

Table I

Robustness / Fragility
Non-Financial Corporations
United States -- 1951 - 1973
(%)

	I	II	III	IV	V
	Fixed Investment ÷ Internal Funds	Internal Funds ÷ Debts	Demand Deposits ÷ Debts	Protected Assets ¹ ÷ Debts	Open Mkt Paper, + Fin Co. Debt ÷ Debts
1951	106.9	14.4	18.8	33.0	1.3
52	95.8	14.7	18.5	31.5	1.6
53	112.2	14.2	17.9	31.5	1.7
54	100.4	15.3	18.5	30.7	2.0
55	90.5	16.7	16.8	29.7	1.7
56	106.6	15.4	15.4	25.1	1.7
57	110.9	15.6	14.7	23.6	1.9
58	100.3	14.2	14.5	23.5	2.0
59	93.0	15.5	12.9	23.7	2.0
60	103.8	14.5	11.5	20.6	2.8
61	97.9	14.1	10.9	20.2	2.9
62	93.1	15.5	10.4	19.7	2.7
63	93.1	15.0	9.7	19.1	2.6
64	90.6	16.1	9.1	17.4	2.7
65	96.1	16.2	8.3	15.7	2.5
66	101.6	15.9	7.6	13.7	2.5
67	104.3	14.8	7.4	12.9	2.6
68	111.1	13.2	6.9	12.0	3.1
69	126.7	11.7	6.7	10.3	4.1
70	131.9	10.6	6.4	10.1	4.3
71	120.8	11.3	6.0	10.5	4.1
72	117.8	12.0	5.5	9.7	4.1
73	128.4	11.4	4.8	8.5	3.8
74	141.1	9.7	4.3	8.7	4.3

Source: Board of Governors of the Federal Reserve System: Flow of Funds Account

¹Demand Deposits, Time Deposits + Government Securities

Table II

Robustness / Fragility
Commercial Banking
United States -- 1951 - 1973
(%)

	Financial Net Worth ÷ Total Liabilities	No Default Assets ¹ ÷ Total Liabilities	Bought Funds ² ÷ Total Liabilities
1951	7.4	58.3	3.7
52	7.4	56.2	3.9
53	7.5	55.9	3.8
54	7.7	55.6	3.9
55	7.8	49.6	4.3
56	8.0	46.6	4.8
57	8.2	45.3	4.8
58	8.1	46.1	4.9
59	8.3	40.7	5.1
60	8.6	39.8	5.1
61	8.5	39.9	6.9
62	8.3	37.6	7.1
63	7.7	33.6	9.0
64	7.6	31.3	10.1
65	7.3	27.9	11.6
66	7.3	26.0	12.2
67	7.0	26.3	13.1
68	6.7	24.7	14.7
69	6.7	21.4	16.9
70	6.4	22.0	17.1
71	6.2	21.9	17.2
72	5.9	20.1	19.5
73	5.9	17.7	24.3
74	5.6	15.2	23.4

Source: Board of Governors of the Federal Reserve System: Flow of Funds Account

¹U.S. Government Securities, Vault Cash and Member Bank Reserves.

²Large Negotiable C.D.'s, Other Inter-bank Claims, Credit Market Debt, Liabilities to Foreign Affiliates, Borrowing at F.R. Banks and Other Miscellaneous Liabilities.

Table III

Funds Raised by U.S. Government and
Private Domestic Non-Financial Sectors
(Billions of Dollars)

	U.S. Government	State & Local Government	Households	Corporate Non- Financial Sector
ANNUAL FLOWS				
1970	12.8	11.3	23.4	39.5
1971	25.5	17.8	39.8	46.3
1972	17.3	14.2	63.1	55.3
1973	9.7	12.3	72.8	67.2
1974	12.0	16.6	44.0	77.1
1975I-III	59.6	10.8	28.7	21.3
QUARTERLY UNADJUSTED FLOWS				
1973I	8.853	2.570	11.900	16.241
II	-5.994	2.468	20.572	20.627
III	-0.457	3.934	19.463	15.311
IV	7.312	3.284	20.880	14.972
1974I	3.389	3.784	3.694	16.479
II	-6.186	4.526	15.534	25.937
III	4.485	4.223	11.918	17.192
IV	10.310	4.023	12.845	17.504
1975I	19.244	3.275	3.262	4.428
II	16.615	4.198	13.296	10.303
III	23.741	3.362	12.172	6.600

Source: Board of Governors of the Federal Reserve System: Flow of Funds Account

Table IV

Non-Financial Corporate Business Financing
Requirements for Fixed Investment
Quarterly 1973I-1975III

	Gross Internal Funds	Fixed Investment	Ratio of Fixed Investment to Internal Funds
1973I	19.919	22.571	113.3%
II	21.448	29.107	135.7
III	21.580	28.291	131.1
IV	21.649	28.659	132.4
1974I	20.355	24.161	118.7
II	20.679	32.168	155.5
III	19.535	29.739	152.2
IV	20.914	28.899	138.2
1975I	21.272	22.746	106.9
II	24.818	29.480	118.8
III	28.282	29.503	100.8

Source: Board of Governors of the Federal Reserve System: Flow of Funds Account