The Sky Did Not Fall in 1975

A. Big Government

In early 1975, the American economy seemed headed toward a depression on the order of the Great Depression of the thirties. Income was declining at an alarming rate, unemployment skyrocketed, banks and financial organizations, corporations and municipalities teetered on the brink of disaster.

The efficacy of official regulatory bodies and supervisory agencies, both federal and state, was in question. Financial disarray, like a contagious disease, threatened to affect all asset values. The situation bore the earmarks of imminent financial crisis.

The financial and economic disturbances of 1974-75 were not isolated episodes of insipient crisis but rather the third such occurrence in less than a decade. The American economy had been exhibiting symptoms of pronounced, pervasive instability since 1966. The credit crunch of 1966 and the Penn Central/commercial paper liquidity squeeze of 1970, each followed a sharp rise in interest rates and implementation of conventional anti-inflationary guidelines and the subsequent rise in interest rates.

1974-75 differed from the earlier episodes in the spread and extent of the financial problems, the depth of the recession, and the sluggishness of the recovery. Yet even though the problems of 1974-75 were far more serious than those of the recent past, neither the disarray of the municipal bond market, the tenuous position of savings and loan institutions, nor the run on the commercial paper market in the aftermath of the Penn Central failure triggered an out-and-out financial crisis.

After the near crisis of 1966—the National Bureau of Economic Research, the scorekeeper of business cycles, did not officially designate this episode a recession/depression—income temporarily stopped its upward climb and unemployment rose slightly. However, the two subsequent traumas—the Penn
The financial traumas and recessions of the 1966-75 period were not the sole indication of our present instability. Those same years also saw the worst peacetime inflation. Every episode of financial crisis was followed by an acceleration in the rate of inflation.

In the last quarter of 1974 and the first quarter of 1975 income decreased precipitously; between March 1974 and March 1975 the unemployment rate jumped from 5 percent to 8.6 percent. In the spring of 1975 failures and bankruptcies threatened or impelled major financial organizations, public utilities, airlines, and business corporations.

And then, the alarming drop of income and rise of unemployment came to a halt. Unemployment peaked at 8.9 percent in May 1975, and by the end of the year the index of industrial production, which in April stood at 109.9, had increased to 113.3 percent in July and had risen to 118.5 percent. In the spring of 1976 the time bombs in our present financial system began to tick away in 1975 and 1976 continued to tick away in 1976 and 1977, it became evident that the financial disturbance of early 1975 had not come to pass. The financial disturbances of early 1975 had triggered neither a cumulative debt deflation nor a deep depression. In the year were on it became obvious that not further serious financial disruptions were in store for us during that recession.

An examination of the events of 1974-75 brings up the question whether, given the actual situation, recovery has occurred, the natural workings of a market economy with its particular structure and institutions, or a planned course of action deserves the credit.
The events of 1974-75 raised the question whether the financial turn-about was due to the natural workings of our market economy with its particular structure and institutions or whether it was the result of conscious policy measures. An unequivocal answer to this question may perhaps not be possible, and it may equally difficult to meaningfully find one definitive answer to why the economic pattern of the seventies failed more unstable than that of earlier years to follow the trenched paths, but it is a point that bears closer examination.

The 1965-75 era differed in crucial ways from the immediate postwar years. The financial system had become crisis-prone. Inflation and interest rates began to climb in the mid-sixties. Prior to that time Federal Reserve measures to halt inflation had not triggered near crises. But now the cumulative changes in financial practices had made the system's crisis-proneness a reflection of the relative robustness or fragility of the financial system is determined by its position on a robustness-fragility spectrum. By 1965 the financial structure of the American economy had become significantly more fragile than it had been in 1945, and by 1974 it had become more fragile still.

This trend toward increasing fragility is the result of cumulative economic developments that changed the character of the system. The increased use of short-term debt to finance capital and financial assets as well as investment. The growing importance of commercial paper financing, liability management banking, specialized financing institutions, and business loans from finance companies are changes indicative of financial fragility. What all these practices have in common is the dependence on loans to repay debts. In other words, when the normal functioning of the economy does not generate the cash needed to repay most of its outstanding debts as they fall due and the debtors resort to refinancing to meet their obligations, we are confronted with a fragile financial system.
By the spring of 1976 optimism about the behavior of the economy was beginning to be voiced throughout the land despite published reports about the "restructuring" of corporate and real estate investment debts and the growing number of business failures. Obviously, the worst fears had not been fulfilled. The financial system had proved to be resilient: It had absorbed heavy blows and substantial losses and had bounced back. The prevailing wisdom had it that whatever problems still remained were bound to be worked out in a new era of prosperity.

But the recovery did not live up to the optimistic forecasts. Its course was dotted with rapid changes in direction. The downward movement in late 1974 and early 1975, a recession was halted in 1976. Despite persistent large-scale unemployment and weaknesses in some sectors, particularly construction, by the spring of 1976 recovery was well under way, only to come to a temporary standstill later that year.

If one is to believe the words of assorted pundits, politicians, and officials, our escape from near crisis and recession in 1973-75 was due to the operations of the market mechanism. In fact, however, the crucial elements in halting the decline were strong fiscal interventions and the prompt lender-of-last-resort measures. The fiscal policies were in part automatic, i.e., massive entitlement (transfer-payment) programs and automatic tax receipts, the result of declining employment, and in part discretionary, i.e., tax rebates and reductions, and extensions of unemployment and other social welfare payments.

Standard economic analysis tends to see the impact of government spending and taxation in terms of the gross national product, rather than the economy as a whole. In an economy with large volumes of private debt, a large government deficit in times of falling production and employment,
helps maintain business profits and household savings. The bonds issued by the government to finance its deficits show up as assets in business, household, and financial portfolios. The financial involvement of big government during a recession makes it possible for private debtors to meet their obligations and reinforces the safety and liquidity of portfolios.

In some respects, the recent past has vindicated the simple Keynesian argument that a large government deficit stabilizes and expands the economy. The experience of 1974/75 shows that fiscal policy, which in earlier days might have been thought to be a strong downward movement of the economy, even in the presence of serious economic problems. On the other hand, the financial relationships that contributed to the economic decline of 1974-75 are not part of the standard analysis of economic developments and policies. Any analysis built upon either the simple Keynesian model or that of the rival monetarists cannot explain recent disturbances. The experience that apparently validates the simplest Keynesian model also reveals that much of significance is ignored in the models. The economic relations involved are more complicated than the models admit. To understand the reasons for what has happened, we must know not only what happened to income and employment but also how the threat of deflation was averted. We must integrate finance into our economic theory.

Before the income and financial stabilizers at the command of big government can make themselves felt, financial pressures threaten the stability of the system. Declining asset values continue to increase the liquidity and solvency of financial institutions, threatening the liquidity and solvency of financial institutions. To prevent problems of this nature from becoming full-fledged crises, the Federal Reserve Bank in conjunction with cooperating private and public institutions must engage in a program of lending of last resort, or refinancing, rescue missions. That is precisely what happened in 1975: The Federal Reserve, the Federal Reserve System, and other financial institutions agreed to undertake lender-of-last-resort, or refinancing, rescue missions.
Deposit Insurance Corporation (FDIC) and various commercial banks, insurance companies and other private financial institutions concerned to head off serious crisis. Thus, when it looked as though the sky was about to fall, the intervention of big government and the activities of the Federal Reserve and cooperating agencies and companies bodied prevented
The Stabilized

Ours is a two-dimensional economy: one encompasses the world of income, employment, and production—what the textbooks refer to as the "real" side. Together with business profits, these jointly determine the course of the economy.

Big government acts as a stabilizer of both these facets. Its transfer-payment schemes free demand from dependence on private payrolls or business profits. The nature of these programs is such that increases in demand tend to increase rather than decrease in periods of recession. Moreover, the deficits incurred by big government have to be offset by surpluses in other sectors. In 1975, the business sector surplus took the form of substantially higher gross profits, which in turn increased the debt-carrying capacity of business. Thus the deficit incurred by the government diminished the pressures that made for a downward debt deflation by business. The 1975 deficit was furthermore offset by an increase in government debt outstanding, by a rise in household savings, which in turn enabled savings institutions and commercial banks to acquire safe assets in the form of government debt instruments and thus improve their liquidity without having to reduce outstanding loans.

A third stabilizing effect is associated with the acquisition of government bonds by business and financial institutions, being safe and secure assets, enhance the security and liquidity of portfolios. Serious recessions are associated with fragile financial structures, but big government tends to increase the robustness of these structures without the trauma of
debt liquidation and deep depressions upon the economy.

The basic destabilizing forces that obviously continue to be at work periodically lead to conditions that are conducive to a financial crisis and feed conditions conducive to deep depression. Big government in its role of consumer and employer and as the operator of transfer-payment schemes is in a commanding position to halt a decline in income. A diminution in the size of government, however desirable this may appear for a variety of unrelated reasons, diminishes the stabilizing tendencies of the economy. Should the economy continue to be in a recession, the economy will be able to withstand and reverse strong downward movements only through discretionary measures. As a minimum recessions will be longer and deeper.

The big government that helps constrain and reverse downward movements lays the groundwork for subsequent investment booms, and in economies given to generous transfer payments, investment booms tend to stimulate inflation. And so we continue to oscillate between accelerating inflations and the threat of depression. Economies such as these are not only inefficient, but because the costs they impose are not evenly spread throughout the system, they are inequitable.

True, we have managed to avoid the massive debt deflations and deep depressions of small governments, but the price we have paid is disruptive inflations and recurrent threats of crisis. To do better we need a big government that depends neither on inflationary military expenditures for an extravagant unproductive transfer-payment schemes.
C. Big Government

Even though our government owns relatively few means of production and provides few direct services, it is nonetheless big. Unlike governments elsewhere, ours neither owns nor operates railways or public utilities, and many of its former operations like military depots and naval installations have been abandoned. These days military production is in the hands of nominally private firms.

In recent years government has grown bigger in terms of its aggregate demand not because it employs a greater number of people but because of the proliferation of a unique variety of transfer-payment schemes that tend to act as income and employment stabilizers during recessions and as stimulants during expansions.

The big government of 1974-75 differed substantially from that of earlier periods. Government spending falls into roughly three categories: government employment and production, which includes services like the postal service, government and military personnel, etc.; government contracts, which encompasses the production of airplanes and missiles; think-tank analyses, highway construction; and transfer payments like Social Security, Medicare, unemployment insurance, family support programs, and local government devices.

Transfer payments are the core of the welfare state. Making their first appearance during the Great Depression, they have blossomed forth into a distinctive form of government spending. As more and more programs, many of them of questionable benefit, were introduced, not much thought was given to the economic consequences of this proliferation.

A transfer payment is a one-sided transaction in which an individual or a group of individuals receives cash or goods or services without having
to give anything in return or making a contribution to the production process. Because the recipient makes no contribution, transfer-payment receipts do not show up in the gross national product even though they become part of consumer disposable income.

In a market economy the value of what workers and owners of a production unit can take out cannot exceed the difference between the unit's sales proceeds and its purchased input for any considerable period of time while the unit runs into financial difficulties. Let us assume the aggregate value of all that has been produced. The value of what an individual producer takes out of that pot is related to the value of his contribution. In the aggregate, transfer payment is a noncontribution. Its counterbalancing claim on output has no such offset. It is a legislated moral or customary act not based on any explicit contribution to output.

An unemployed worker receiving unemployment insurance checks is not currently making a contribution to production. However, if that same worker were to receive that same amount of money for work on a public project his contribution to the gross national product would presumably equal the money he receives. If a given public works project is a salable product the payments received are less inflationary than unemployment insurance. If the output is not marketable, but becomes part of the community's useful production it makes a contribution to the commonwealth. Even though unmarketable, efforts tax expenditures. On the other hand, public works produces the income received is every bit as inflationary as unemployment insurance payments. The military payroll and defense contractors' payments that do not contribute to current production they are, as inflationary as transfer payments of like magnitude.
As transfer payments proliferated, government spending—and consequently disposable income—increased, but this increase did not affect either measured employment or GNP. Of course, we are dealing here with problems of measurement and definition. If the government were to spend the same amount of money it is channeling through Medicare on the direct payment of medical services directly rather than reimburse the patient for these expenditures would fall into the category of purchased goods and services, not transfer payments. Just as public schools are classified as government production rather than as a transfer payment, so too are these services.

How does government affect employment and output, sectoral deficits and surpluses, financial instruments and balance sheets? In the realm of government employment and contracts its effect on employment and output is direct; in the area of transfer payments it is indirect, depending on how the distributed funds are spent, and thus the sectoral surplus/deficit aspect takes on special importance. In an economy with a fragile financial structure as ours in recent years, the effect of sectoral surpluses and deficits plays a relatively larger role than in a more robust structure. But one thing has become painfully obvious: Given a fragile financial structure, any attempt to maintain a balanced budget when the economy moves into recession is bound to make matters worse.
The Stabilizing Effects of Big Government

Big government was largely responsible for halting the sharp decline in late 1974 and for stimulating the strong expansion that followed.

Government, through its demand for and distribution of goods and services, affects income and employment, and by creating sectoral surpluses and deficits it affects sectoral budgets. Still another effect concerns portfolios, since the debt incurred by government in the financing of its programs shows up as an asset in various portfolios. The first of these effects is generally known and is treated in the models demonstrating how the GNP is determined. The second and third of these effects are frequently ignored, even though they are important, in view of the fact that ours is both an income-producing and income-dispensing system in addition to being a complicated, interdependent, sophisticated financial structure.

Once all these aspects of government deficits are seen for what they are, it becomes obvious that big government is a far more powerful and pervasive stabilizer than the standard view admits.

The precipitous decline of 1974 was reversed primarily because the government simply threw money at the problem without regard to either benefits or costs. In view of the government's demonstrated ability to brake a steep decline through greater spending and tax cuts, the salient issue is not deficit spending per se but rather the efficiency and value of specific programs and the effects and specific policies, in particular the inflationary consequences of different approaches. We know how to stop a sharp downward movement; what we do not know is how to achieve the desired objective with a minimum of dislocation. A government big enough to undertake incisive measures must not only concern itself with ultimate results but must also ask itself how we shall produce what
The Effects on Income and Employment

The conventional approach theory of income determination stresses the effects of government spending and taxes on income, employment, and production. The government in its role of employer or purchaser of goods and services creates jobs, or creates income through the implementation of various transfer-payment programs. In turn, the government derives its income through the taxes it levies. In its role as employer or purchaser the government presumably provides a needed service or acquires a useful product, but the economic impact of transfer payment is felt only when the recipient spends the money given him.

The simple view of standard theory on the effect of government deficits is based on the definition of aggregate demand as the sum of consumption, investment, and government spending. Consumption spending, as expressed in a so-called consumption function, is said to depend on disposable income, on wealth or net worth, and on the use of financial assets to acquire still more financial assets, i.e., "interest."

Disposable income comprises the sum of wages, salaries, interest, dividends, and transfer payments, minus direct taxes. The government deficit enters into the calculation only in the relation between direct and indirect household receipts derived from government expenditures and transfer payments, minus income taxes. This simplified view ignores the cash-flow relation that follows from the government deficit and the instruments used to finance it. The income/spending relation expressed by the consumption function is valid as far as it goes, but it does not go deeply enough into the effect of government on production, employment, prices, and financial stability. In this analysis of the effect of government on aggregate demand, government spending in itself becomes a component of aggregate demand. But government spending in this context refers to spending
on goods and services. Transfer payments are not directly included. They enter into the determination of income and employment only via their effect on disposable income and consumption. Because of the method of measuring persons used, money spent on hiring workers for public works projects has a greater impact on GNP than a like amount distributed for welfare or unemployment insurance payments. For example, if 50 percent of the $200 billion paid out in social security benefits in 1975 had been distributed as wages in public programs for the aged, the GNP would have been some $40 billion higher. Whether providing income for the aged through jobs in either the private or public sector is preferable to transfer payments is clearly a normative economic and sociological question.

Military expenditures also enter into GNP as a government purchase of goods and services, regardless of whether the purchase is utilized or not. Nevertheless, the distinction between the way in which transfer payments, taxes, and government spending on goods and services figure in the calculation of GNP is valid only if we divorce the measure of GNP from any connotation of welfare and treat it simply as a measure of production transformed into a demand for labor, i.e., employment. Government purchases of goods and services, be they office supplies or military aircraft, personnel or legislators, bear directly on employment, while transfer payments and taxes affect disposable income and, consequently, employment, even though indirectly.

The simple, straightforward way in which government affects income and employment is an important part of the picture, but it is not the whole picture. Government spending, especially in excess of tax receipts, is a determinant of income. How did the various components of government spending fare between 1950 and 1969 and during the subsequent seven years of ostensibly conservative rule? Between 1950 and 1969, total government
purchases of goods and services increased by a factor of 5, transfer payments to individuals by a factor of almost 5, and transfer payments to states by a factor of almost 9. During this period of relatively liberal administrations, government purchases of goods and services increased by about the same rate as transfer payments to individuals. But in the seven-year period that followed, government expenditures increased by some 95 percent, and purchases of goods and services rose by 25 percent; national defense accounted for 10 percent of these latter expenditures and civilian functions for the remainder. On the other hand, transfer payments to individuals rose by 200 percent. While such payments accounted for approximately 50 percent of the government’s purchase of goods and services in the 1950-69 period, in 1975 individual transfer payments were 20 percent higher than the purchases of goods and services. This explosive spurt meant that about one out of every six dollars spent by or for households was distributed by one or another federal or state program. Unemployment insurance payments rose from an annual rate of $5.3 billion in the second quarter of 1974 to $19.4 billion in the second quarter of 1975. This dramatic rise may help explain the halt in the downward momentum, but high, long-term unemployment insurance payments are inflationary both during the decline and during the recovery, for they affect the demand for production as well as the supply of labor.

Between 1973 and 1975, when government purchases of goods and services increased by 20.6 percent, transfer payments to individuals rose by a startling 56.8 percent, and grants-in-aid to state and local programs by 33.5 percent. During this same period the GNP deflator increased by 19.3 percent. Thus, while the deflated government purchase of goods and services increased at approximately the same rate as the price deflator,
transfer payments to individuals increased. The persistence of inflation even in the face of rising unemployment is obviously related to the rise in transfer payments.

Throughout this period the government deficit continued its steady upward climb from an annual rate of $6 billion in the third quarter of 1974 to the dizzying heights of $102.2 billion in the second quarter of 1975. This jump was reflected in a sharp decline in income tax collections (from an annual rate of $137.2 billion in the first quarter of 1975 to $99.3 billion in the second quarter), and in a drastic increase in transfer payments (from an annual rate of $136.2 billion in the first quarter of 1975 to $147.3 in the second). Thus, disposable personal income, which increased by 6.2 percent between the first and second quarter of 1975, kept pace with escalating unemployment.

Leaving aside the crucial question about the efficiency and equity of an economic system in which one-sixth of total disposable income derives from entitlement programs, no one will deny that making such income available is a good thing, but neither can its inflationary impact be denied. Inefficient and inequitable transfer-payment programs raise the price at which people are willing to enter the labor force and erode the productive capacity of our economy. Yet they remain the accepted responses to economic malfunctioning because they relieve the policy makers of the responsibility of facing up to the inherent problems of our economic system, of re-examining concepts and programs that make nonparticipation in the labor force the criterion for eligibility and income.

What pulled us out of the 1973-75 recession was big government, however flawed its programs, not wise decision-making. The debate should therefore center not on whether, but what kind of, big government, and for whom.
### Chapter II

#### Table D

**Sectoral Surpluses and Deficits 1972-75**

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<td>Disposable Personal Income</td>
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<td>Personal Outlays</td>
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<td>Personal Saving (Surplus)</td>
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<tr>
<td>Gross Internal Funds</td>
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<td><strong>Total Surpluses</strong></td>
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<td>78.7</td>
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<td><strong>Discrepency</strong></td>
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<td>Households Savings as % of Disposable Personal Income</td>
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<td>Business Deficit as a % of Gross Private Investment</td>
<td>26.73</td>
<td>35.88</td>
<td>32.4</td>
<td>10.95</td>
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**SOURCE:** Presidents Economic Report: Table B-18
The Effects on Sectoral Budgets

A vital aspect, yet one ignored in the standard analysis, is embodied in the proposition that the sum of surpluses and deficits of all sectors of the economy must equal zero, for each time a sum of money is paid out by one unit another unit becomes a recipient. Thus, if the money spent by the government exceeds its tax collections—and in 1975 that overspending amounted to $73.4 billion—the sum of the surpluses and deficits of all the sectors had to equal that amount, and it had to show up as either a bigger surplus or smaller deficit for households, businesses, etc., than would otherwise have been the case.

The household sector surplus or deficit can be measured by the difference between disposable income and expenditures. Except in times of deep depressions, and then only in economies with small government sectors, the household sector almost always generates a surplus, though it may vary considerably from year to year. Every increase in the household saving ratio is coupled with an increase in a deficit: In 1973 that deficit accrued to the business sector, and in 1975 it was sustained by the government. (See Table ...)

The behavior of business deficits is Perhaps the most remarkable feature of the 1972-75 sectoral surplus/deficit pattern. The business sector is the private investment area. Its deficit—the excess of plant and equipment, inventory, and "corporate" housing investment over internal funds (retained earnings plus capital consumption allowances)—amounted to $47.9 billion in 1972, jumped to $79 billion in 1973, remained at a high level, $67.6 billion in 1974, and fell sharply, to $21.5 billion, in 1975. As a percentage of gross private investment it rose from 26.7 percent in 1972 to 35.8 percent in 1973 and 32.4 percent in 1974, before falling to 10.95 percent in 1975.
Total government deficits (federal plus state and local) registered a $10 billion swing in both 1973 and 1974 (decrease in 1973 and increase in 1974), and a $60 billion increase in 1975, which showed up as either a decrease in deficits or an increase in surpluses in other sectors. Part of it appeared as a $15.6 billion increase in household savings, which was tantamount to a jump in the household savings ratio to 8.92 percent of personal disposable income. It furthermore showed up as an enormous $33.1 billion in business gross internal funds, a rise of 23.4 percent. In a year that saw a major increase in unemployment and a sharp decrease in price-deflated GNP, gross business profits increased by 23.4 percent. The behavior of gross business profits in 1975 is a measure of the power of government deficits as a "budget" stabilizer.

A further component of the business sector's budget that helped offset the rise in the government deficit was a $13.2 billion fall in investment, due largely to an inventory liquidation, a liquidation that took place mainly because the large government expenditures and reduced taxes sustained disposable income.

The $60 billion dollar rise in the government deficit thus was offset by a $15.6 billion rise in personal savings and a $46.3 decrease in the business sector deficit, which in turn was due mainly to a $33.1 billion increase in business gross internal funds. In other words, the government deficit was largely offset by a rise in corporate cash flows. Business profits were sustained and even increased while the country was in the grip of a severe recession.

In our economy business is conducted within a system of borrowing and lending based on margins of safety. Two measures of these margins of safety are the cash flows going to the debtors and the present value over the future.
The boom of the seventies and the evolution of the economy during the postwar era were coupled with a large increase of short-term debt by business and a proliferation of financial institutions that underwrote such debt by using their own, usually short-term debt instruments. The internal funds generated by that operation largely determine how much short-term debt business can carry. In the absence of big government and the huge deficit generated in 1975 a plunge in the economy like that of 1974-75 would have brought with it a plunge in corporate cash flows, and a decline in the debt-carrying capacity of business. And even if there had been no bankruptcies such decreases would have forced business to limit its commitments. But what happened instead was an increase in gross profits.

This overview of sectoral surpluses and deficits is based upon accounting factors, but accounting factors do not deal with behavior patterns. Moreover, a presentation of accounting factors does not make a theory and does not lead to causal inferences. To understand what happened we have to look at the result—find out how the result—the sum of the surpluses and deficits across all the sectors equaling zero—is achieved. This demands that we formulate ideas about the determinants and the determined items in the accounting tables. That means we have to introduce assumptions as to how the economy actually works to assure the end result of the sum of surpluses equaling the sum of deficits.

One theoretical assumption holds that the relation between personal income and expenditures is to a large extent a passive one, and that consumption and savings change as income changes. This assumption of a passive savings and consumption behavior dependent in large part on the behavior of the economy is attenuated by the existence of both household
wealth and consumer debt. Forty years ago, when Keynes first formulated theories in terms of passive consumption behavior, household wealth and consumer credit did not loom nearly so large in the total economic picture.

If, during a recession, outstanding consumer credit remains stable for a period of a year or so, and disposable income remains stable or perhaps increases, the liquidity position of households will improve, and this ultimately will lead to increased consumer spending. As liquid assets increase and debt in relation to income decreases, the spending/disposable income ratio of households tends to increase. Consequently, a period of high savings ratio such as 1975 will be followed by one of low savings/disposable income ratio, turning the consumer into a heroic figure who leads the economy out of a recession. But that heroism is nothing more than the delayed response to the high savings ratio of the recession.

This variability in the savings/income ratio demonstrates that consumer behavior is not a completely passive affair, and that the relationship between consumer spending and the state of the economy is a relatively stable one. We know, for example, that personal expenditures will almost always account for 91-95 percent of disposable income. Moreover, if the savings ratio is high for a time, say in the vicinity of 8-9 percent, it will be followed by a burst of spending that will bring the rate down to about 6 percent.
Projections of

Two pivotal factors, business investment and government spending, are
determined independently of the operations of the economy at any given
time. Business investment is based largely on projections of future be-
though the past and present state of the economy obviously bear
directly on the scale and financing of planned undertakings.
The financial markets play a crucial role here, for they determine how
business can get money today for tomorrow's plans. Their approach to
the financing of business deficits reflects current views about future
prospects, which in turn are influenced by the accumulated volume of
debt relative to current and expected cash flows.

The other independent item, government spending, appears in the
table on the surplus side under the rubric "government deficit."
Government spending, particularly federal spending, must be divided into
two categories: expenditures for goods and services, primarily congressionally mandated "national defense" items, and transfer-payment programs,
which are directly related to the behavior of the economy.

The increase in the annual outlay for unemployment insurance between
1972 and 1975, from $5.6 billion to $17.5 billion, told us much about the
effects of entitlement programs. This explosive rise was in part the
result of legislated time extensions and increased coverage. The primary
cause, however, was the rise in unemployment.

Entitlement programs and taxes are automatic stabilizers that respond to
changes in income and employment. As income and employment decline, outlays
for entitlement programs increase and tax receipts decrease. Given the
size of the tax bill and of the entitlement programs, a large government
deficit is bound to accompany any sharp rise in unemployment and any marked
decline in industrial production and "tax law" corporate profits.
Because consumer spending accounts for a large portion of total spending, even a slight variation up or down in the consumer savings ratio will have an impact on total demand. Consequently, a decline in income resulting from growing out of a decline in investment spending or a rise in the consumer savings will trigger greater disbursements by entitlement programs and lower tax receipts. This development, combined with other government expenditures, will lead to a growing government deficit which in turn must be offset by a parallel movement toward surplus in the business and household sectors. If the business sector surplus takes the form of higher gross profits after taxes, its debt-carrying capacity will have increased even in the face of threatening recession. And concurrent with the government deficit the household savings ratio will also go up. In other words, consumer spending will increase autonomously once the downward movement is halted and the higher household savings ratio has brought about a decrease in household indebtedness.

Let us imagine for a moment that the government budget is always balanced and that the acceptable deficit is small. What would the table then look like? In that case the surplus of the household sector would have to be offset by deficits from the business sector. Had that been the case in 1975, private investment would have fallen even more than it did because of greater inventory liquidation and a decrease if not outright abandonment of existing investment programs; and disposable personal income would have fallen more rapidly than it did, and more rapidly than personal outlays. Consequently, the deficit financing personal savings offset by deficit financing would have been smaller. Thus, in the absence of large government the retrenchment of investment brought on by balance sheet constraints would have led to a cumulative downward movement.
With its potential for massive deficits big government sets a limit on the downward movement of the economy, no small matter in a world of business and personal debt. Were it not for the huge government deficit of 1975, the debt-carrying capacity of business and households would have been severely curtailed, an impairment which in the past has led to open-ended deflations.

Balance Sheet Implications of System Behavior

The financial instruments absorbed or generated by the surpluses or deficits of big government are yet another facet of the economic scene. In times of growing government deficits and in times of recession, various sectors, among them financial institutions, will acquire debt instruments to help finance the deficit.

In our complex financial structure the sectors showing surpluses do not have to acquire the government and business liabilities directly. They can do so indirectly by acquiring the liabilities of financial institutions—banks, savings institutions, insurance companies, pension funds. The assets held by financial institutions tend to reflect the direct impact of swings in deficits or surpluses among the various sectors.

Between 1972 and 1974, the acquisition of government debt instruments by the private sectors followed a fairly stable pattern, even though the totals rose slightly from year to year. In 1972, commercial banks, savings and loan associations, and mutual savings banks were the major acquirers, while in 1973 and 1974 the nonfinancial sectors, particularly households, took the lead, although 1974 saw a net acquisition by the financial sector, largely mortgage-related savings and loan associations, a reflection of the looming decline in housing construction.
In 1975 the pattern of net acquisition underwent a marked change. Although the nonfinancial sectors continued to acquire the same amount of government securities as in the two preceding years ($20 billion), household savings, in sharp contrast, decreased, and nonfinancially business increased its share by $16.1 billion; state and local governments also increased their holdings. The biggest change, however, took place in the financial sectors; their total acquisitions ($57.1 billion) were $50.4 billion above their 1974 holdings. These massive acquisitions were instrumental in financing the government deficit, and in the process their balance sheets underwent major changes.

Government debt, unlike private debt, is risk-free and, moreover, marketable. Its marketability is guaranteed by the Federal Reserve, and no other debtor enjoys a similar advantage. In acquiring government debt instruments the various financial institutions were so to speak able to "store" financial power at a time when demand for private financing was slack and hold it until such a time when the demand for it would grow strong. The inflationary potential of a deficit like that of 1975 is not really felt until later, when the assets acquired during the recession are taken out of storage.

In 1973, bank loans to business made up more than 50 percent of the net assets of banks, that is to say, the banking sector was channelling its financial resources into the private sector. But in 1975, a year of recession, almost all the financial assets acquired by the banks—$30.3 billion out of a total of $32.9 billion—were in the form of government debt. Bank loans to business and consumer credit fell off, as did mortgage acquisitions. Banks channeled their resources toward government and away from business.
Concomitant with the increase in government debt and deficit of 1975, banking and other portfolios were able to acquire risk-free, marketable assets as income and employment fell off. Business indebtedness decreased while banks increased their total assets and total liabilities. In an economy marked by a big government the money supply can increase while private indebtedness to banks decreases.

When government was small and its indebtedness relatively large, government debt in private portfolios, including bank portfolios, could not increase substantially during a recession. A decrease in private business debt also meant a decrease in demand and time deposits. But in 1975, because of the large and increasing volume of outstanding public debt in private portfolios, no such cumulative interactive decline of business debt and demand and time deposits took place. Because of the indebtedness incurred by big government, business and bank portfolios became less risky. The public, whether households or business, not only was able to acquire safe assets in the form of bank and savings deposits, but it was also able to decrease its relative indebtedness. The large government debt thus acted as a stabilizer of marketable portfolios.
The Sky Did Not Fall: The Lender of Last Resort

In 1974-75, a time of financial distress, falling incomes, and growing unemployment, more banks, and banks with more assets, failed than in any other period since the end of World War II. The REITs—Real Estate Investment Trusts—a financial industry owning some $40 billion in assets, could not meet their payment commitments; the only thing that kept them out of overt bankruptcy was the reluctance of their creditors to press their claims. New York City found itself unable to roll over its floating debt. A major national chain store, W.T. Grant, failed. Consolidated Edison was forced to sell some of its assets to the state of New York to meet payment obligations, and Pan Am Airways faced bankruptcy. These were some of the more spectacular financial disasters of that period, any of them could have triggered a panic and a dramatic decline in income, employment, and profits. However, this did not come to pass, and the reason it did not was the huge government deficit, which not only maintained demand but assured business profits despite declining incomes, coupled with the prompt, effective lender-of-last-resort intervention of the Fed, the FDIC, and cooperating private banks.

While big government acts as a stabilizer through its demand for financial flows, lender-of-last-resort action acts as a stabilizer of assets and portfolios through its readiness to purchase assets and substitute risk-free liabilities for risky portfolio holdings. And while big government influences aggregate demand, sectoral surpluses, and the acquisition of government liabilities by private portfolios, lender-of-last-resort intervention affects the value of existing assets and the terms and availability of refinancing.
If in a traumatic situation such as the one just described a deep depression is to be averted, the lender of last resort must intervene promptly, set a minimum on asset values, and obviate the necessity of the sale of assets to meet obligations. If a unit, be it a bank or business or local government, is forced to refinance its position through extraordinary channels, the lender of last resort must either accommodate it or agree to a debt deflation.

The need for lender-of-last-resort intervention will make itself felt even before the automatic stabilizers of big government come into play. If in the face of a steep decline in income and allows market forces to operate, asset values will decline at a precipitous rate, and along with them, investment, debt-financed consumption, employment, and profits. Should such a development gain momentum the financial crisis and consequent debt deflation will overwhelm the stabilizing capacity of big government, though at least temporarily, in time this trend will be halted. Eventually big government will force profits on business and put safe assets into portfolios. But in the absence of effective lender-of-last-resort action the depression is bound to be deeper and continue for a longer period.

In 1966, 1970, and 1975–75, the Fed's lender-of-last resort activities played a vital stabilizing role, yet that function and its implications are poorly understood not only by the general public but also by the political and academic community. Understanding requires the recognition that our economic system is inherently flawed but conventional economic theory refuses to admit that the observed flaws are inherent, that market capitalism, if left to its own devices, will periodically undergo bone-crunching depressions.
Instability, be it financial or social, gives rise to reform and change. Both the Federal Reserve System and the FDIC were the products of instability, the first of the panic of 1907, the latter of the Great Depression. The financial traumas of the recent past have not stimulated similarly incisive steps designed on behalf of stability, most likely because the recent events were not quite as traumatic as those two. But the road has certainly not been smooth. Lender-of-last-resort intervention sets the stage for inflationary bursts. The recent instability, the veering between runaway inflation and debt deflation, between boom and bust, is simply a side effect of the successful avoidance of a serious depression.

The Cushioning of Financial Repercussions

By the fall of 1974 the banking and financial fabric had become so weak that Arthur Burns, the then chairman of the Federal Reserve, [expressed concern over the continued soundness of the banking system (in an address questions had been raised about to the American Bankers Association) After noting that the strength of the nation's and world's banking system, he subjected to five reasons for that concern:

[F]irst the attenuation of the banking systems' base of equity capital; second, greater reliance on funds of a potentially volatile character; third, heavy loan commitments in relation to resources; fourth, some deterioration in the quality of assets; and, fifth, increased exposure of the larger banks to risks entailed in foreign exchange transactions and other foreign operations [Federal Reserve Bulletin, November 1974, pp.00].

Burns concluded his talk by acknowledging that "our regulatory system failed to keep pace with the need," and noted that "a substantial reorganization [of the regulatory machinery] will be required to overcome the problems inherent in the existing structural arrangement."
Chairman Burns spoke as the last rites were being administered to the Franklin National Bank and as the sharp downward plunge of income in 1974-75 was gaining momentum. The weaknesses acknowledged by Burns were not confined to the banking system. Other financial organizations and markets were similarly troubled. As a result, the financial structure in late 1974 and through 1975 underwent its most severe stress since the early 1930s.

The weaknesses pinpointed by Burns grew out of the way the banks and the financial system had evolved during the postwar years. The critical link weakness of Burns's speech lay in his failure to examine the problem to the fundamental flaws of our economy, rather than the blame on flailing regulatory zeal or trivial organizational shortcomings.

The dislocations of 1974-75 were the third instance since 1966 calling for Federal Reserve lender-of-last-resort intervention. In fulfilling this function, the Fed refines positions of banks (and thus possibly indirectly of other institutions) that private lenders can be found to refuse to finance. Since this refinancing enables the recipient to pay other debts, lender-of-last-resort actions in essence validate debts when the debtor's assets prove insufficient. Thus, losses on assets remain confined to the organization under pressure and are not passed on to other units. In case of a bank failure, depositors, though not stockholders, are protected against losses; they are absorbed by the Federal Reserve and the FDIC. Lender-of-last-resort actions cushion the impact of financial disasters.
Similarly, if a consortium of commercial banks agrees to refinance a problem market or unit in difficulties, such as the commercial paper market in 1970 or the REITs in 1974, it is acting as a lender of last resort. The difference between this refinancing and that undertaken by the Federal Reserve. The action of the banks leads to a weakening of the financial position of private institutions, whereas no such weakening occurs when the Federal Reserve does the refinancing.

Given the recurrent need for lender-of-last-resort assistance and the similarity between this condition and the instability of the prewar years, it might be assumed that the Federal Reserve would have come to the conclusion that the instability that continues to plague us is inherent in our particular financial structure, the Federal Reserve is the ultimate though not necessarily proximate supplier of requisite financial resources.

Since the successful exercise of lender-of-last-resort functions ties the hands of the Federal Reserve with respect to operations designed to control income, employment, and prices, and extends the domain of its tends to be guarantees to new markets and instruments, it for the revalidation of an instrument guarantees its future value. Unless the regulatory apparatus is extended to control, constrain, and possibly even bar the practices that bring lender-of-last-resort intervention into play, success in preventing deep depression and slowing down inflation will be transitory at best. If we want to avoid crisis-proneness growing out of speculative financial practices we must institute reforms that will constrain banks and related institutions from financing explosive ventures.
The Bank Failures of 1973-75: "Central Banking" as Lender of Last Resort

1973-75 witnessed a wave of bank failures reminiscent of the Depression years. Even allowing for the economic expansion and the trend toward giant and branch banking, the magnitude of the failures of four banks that necessitated central intervention is an indicator of the problems that beset banking. The dollar resources of these stricken banks exceeded the totals of previous similar debacles, although the near total collapse in 1933 was proportionately a larger failure.

Yet despite the fears that the sky was about to fall, the failures and assorted financial problems did not set off a chain reaction of plunging production, prices, and employment. One reason was the concurrent vast increase in the government deficit, and the other was the exercise of lender-of-last-resort functions by the Fed and other institutions. The government deficit put a brake on downward movement of income, and the lender-of-last-resort intervention effectively prevented the bank failures and their deleterious effects on other financial and business organizations as well as local and state governments. Consequently these failures were seen as isolated incidents rather than what they in fact were—symptoms of a defective system.

The United States National Bank of San Diego was declared insolvent on October 18, 1973, and the Franklin National Bank of New York was closed on October 8, 1974. Each had assets of more than $1 billion, as did the Security National Bank of New York, which was "merged" in
early 1975 to stave off failure. And during that same period the billion-dollar Commonwealth Bank of Detroit was being kept afloat by extraordinary loans from the Federal Reserve.

Instead of being closed or liquidated, these almost failed or failed banks were merged with other institutions. And even though legislation limits the liability of the FDIC for deposits, the merger of the stricken banks with solvent institutions meant that all deposits were fully honored. Both the United States National Bank and the Security National Bank were absorbed by larger institutions, and they continued their operations under the control of these new banks. Franklin National Bank was taken over by a well-connected smaller organization, which also continued the operation of Franklin's offices.

The failure of these billion dollar institutions was followed by the collapse or near collapse of numerous lesser banks. Thirteen banks failed in 1975, and in the first ten months of 1976 another 14 followed suit. Even though none of these was in the billion category, their holdings were by no means puny: one of them had assets of 3475 million, another of 268 million, and four had assets ranging from 100 million to 200 million. In 1969, a year which also saw a flurry of bank failures, the assets of the largest of the nine banks that either failed or were absorbed by another institution amounted to 11.4 million. So even if we ignore the billion-dollar blockbusters and the greater number of banks involved, the failures of 1974-76 moved on a substantially higher plane.

Between 1934, the year of the FDIC's creation, and 1972, 496 banks holding total deposits of 1.1 billion folded. Between 1972 and 1974, the total number of bank failures grew to 506, and their total deposits amounted to 3.6 billion, triple the amount of the preceding 38-year period.
Bank examiners classify loans on the basis of predictable problems. The relation between the dollar amount of a problem loan and a bank's capital funds determines its categorization, and the regulatory agencies exercise closer supervision over problem banks than over others.

In early 1976 official listings of problem banks were made public, and included in that category was the Chase Manhattan Bank of New York, the nation's third largest bank. Yet neither the recent rash of bank failures nor public knowledge of the problems of major banks set off the sort of run of past years. The reason for the public calm was the Federal Reserve's lender-of-last-resort rescue of Franklin National and its successful handling of the problems of smaller banks.

The Failure of Franklin National Bank

At the end of 1973 Franklin National Bank ranked twentieth in the United States, with total assets of approximately $35 billion. Within ten months, on October 8, 1974, it was declared insolvent and its deposits were taken over by the European-American Bank. On that date its assets had shrunk to $3.6 billion, of which $1.7 billion were financed by borrowings at the Federal Reserve Bank of New York. What were the underlying causes of the failure and how did the Federal Reserve handle it?

Given the fact that Franklin's collapse did not create a panic—though it may have played a part in the precipitous decline of late 1974-early 1975 and the halting pace of the recovery—the Fed's lender-of-last-resort operation was presumably well executed. But in conducting its rescue operation, the Fed also enabled Franklin National to honor its obligations to the depositors in its overseas branches, thereby extending FDIC protection of domestic deposits to overseas operations.
Franklin National apparently conducted three separate operations under one single corporate umbrella. As a retail bank on Long Island, it was fully competitive, and apparently profitably, with other banks in that suburan market. In its second role it functioned as a wholesale bank in New York City, entering that operation in 1964 as an aggressive seeker of deposits and loans. Here, however, it did not fare quite so well. The third part of its business, the overseas operation, was launched in 1969 with the opening of a branch in London. Its funds, "bought," often at a premium, in the London market, were used to extend loans in the European dollar market, frequently at small interest rates spread above the cost of money. By the end of 1973, Franklin National had about 31 billion in deposits at its London office, another 1.4 billion at its New York wholesale branch, and some 2.6 billion of assets/liabilities in its retail operation, mainly on Long Island.

The problems Franklin National experienced did not come about suddenly in 1974. They began with the expansion to new areas of business concurrent with persistent problems in its base operation. As early as December 1972, Franklin held 3193 million in loans, 10.6 percent out of a total loan portfolio of $1,821 million. Examiners classified this as substandard. In June 1974, when the run on the bank had already begun, substandard loans made up 12.7 percent of the total loan portfolio. The weak position of the bank's domestic loan portfolio helped pave the way to bankruptcy.

Franklin's earning record bore out its weak position. Even before its problems surfaced, its earnings as a percentage of total assets were low. The earnings ratio of 0.66 percent; and by 1972, when other large New York banks showed earnings of 0.78 percent, Franklin's had dropped to a mere 0.30 percent. A 0.30 per dollar return on assets does not leave much margin for error or profit erosion. As the economy entered into a period of double-digit inflation and double-digit interest rates, Franklin Nationals' cash flow, asset values, and liquidity suffered a decline. By early 1974 its earnings had evaporated, and its asset declined. By May 17, soon after its difficulties had become common knowledge, the assets were down by about $400 million; money-market liabilities amounted to $400 million, a decline of about $700 million in two weeks, and deposits at its foreign branch were down $160 million. That branch now owed the head office some $160 million. To offset these liability losses and the erosion of other deposits, Franklin National borrowed $365 million from the Federal Reserve.

*One other aspect of Franklin National's situation is worth noting, though its full significance cannot yet be determined since the issues are still in litigation. In 1972 a Luxembourg corporation, wholly owned by Michele Sindona, acquired a controlling interest—21 percent—in Franklin National. The purchase price, some $40 million, gave Sindona control over 35 billion in assets, i.e., $125 of assets for every dollar invested. The question is whether the private profit of a principal in a corporation is not perhaps best served by deals not in the best interest of the other stockholders and the regulatory authorities. Bank accounting, especially in foreign-exchange transactions, is so imprecise that a thin-equity investor controlling an operation like Franklin National might perhaps gain by conveying bank assets to his personal portfolio. This aspect of Franklin National's history raises questions about the ability of publicly owned corporate banking to act as honest fiduciary for noncontrolling stockholders, depositors, and the insurer.*
The behavior of Franklin National's Federal Funds and due-to-bank accounts reflected the banking community's lack of confidence in that bank. Between May 3 and May 17, its Federal Funds liability dropped from $500 million to zero, and its due-to-bank accounts were down from $300 million to $15 million. Domestic demand and time deposits also declined, the first by about $100 million and the latter by $30 million. From that time onward until its closing, Franklin National Bank became increasingly dependent on the Federal Reserve Bank. By the end of July Franklin National borrowed some $1.4 billion at the Federal Reserve, and some $350 million of the liabilities of its foreign branch were the home office's. Domestic demand and time deposits had plummeted to $1.2 billion from $1.8 billion on May 3. The protection given by the Federal Reserve enabled the bank to raise some funds through the Federal Funds market.

From a purely technical perspective the refinancing of Franklin National by the Federal Reserve Bank of New York was a beautifully executed feat. There was no obvious general panic nor a flight from the Eurodollar market or bank certificates of deposit. This relative serenity prevailed despite the almost simultaneous failure of a large German bank. Two international bank failures within so short an interval might well have created havoc in the financial markets of the world were it not for the Federal Reserve's validation of the deposits in Franklin National's London office. There can be no question that the Federal Reserve's action was right. Where it erred was in its subsequent failure to seek deep-reaching reforms in the overseas operations of American banks.