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Money Manager July 10 1978

By HYMAN P. MINSKY

U.S. Efforts to Prevent Deep Slump Fan Inflation, Render Policy Helpless

The U.S. from its founding through the Great Depression of 1929-33 suffered from periodic financial crises which were associated with debt deflations and deep depressions. Since World War II no fully realized financial crisis has occurred and we have not had a deep depression.

Following bursts of inflation immediately after World War II and when the Korean War started, there were 14 years of relative tranquility. During 1952-66 unemployment and inflation were low by today's standard, and there was no threat of a financial crisis.

Beginning in 1966 there have been three serious threats of a financial crisis; the credit crunch of 1966, the Penn-Central commercial paper crisis of 1970, and the Franklin National Bank failure/REIT crisis of 1974/75.

In each case lender-of-last-resort intervention by the Federal Reserve and other banking authorities aborted a debt-deflation process, and the demand and financial repercussions of big government assured that a deep depression did not happen.

It has become evident in the years since 1966 that the processes that make our type of economy cyclical are still at work but that with big government the result of these processes is different than with small government.

The chronic inflation and recurrent financial crises since 1966 are linked. What banking authorities do to prevent a financial crisis from becoming a debt deflation and what the government does to stop the threat of a depression lead to a subsequent inflation. Roots of today's inflation lie in Federal Reserve and government actions in 1974/75.

Our economy is characterized by the use of debt to finance investment

What banking authorities do to prevent a financial crisis from becoming a debt deflation and what the government does to stop the threat of a depression

Established financial institutions such as commercial banks take on new functions, issue new types of liabilities and finance activity through exotic assets. Bankers respond to the strong demand for their services by raising the ratio of their assets to equity.

Because of the evolution of financial practices, the supply of finance is responsive to the demand for finance. Because the Federal Reserve does not control financial evolution, the Federal Reserve cannot control the volume of activity financed.

An investment boom is the normal result of our type of economy doing

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well over an extended period. The fundamental instability is "upward" from doing well to a boom, because doing well leads to higher capital-asset prices as profits rise and seemingly become assured. In addition, doing well increases the financing available for holding capital assets and producing investment.

However, as an investment boom proceeds, the demand for finance outruns the increased supply available from institutional evolution and portfolio adjustments. This puts upward pressure on both short- and long-term interest rates. Higher short-term interest rates increase the cost of investment even as higher long-term interest rates depress the value of capital assets. This scissors effect decreases the pace of invest-

This leads to further declines in investment and profits. In our economy debt structures that can be validated only if investment and profits increase are built even as financial market processes that decrease investment and profits are set in motion.

Firms and financial institutions that need to sell liabilities, even as their profits decrease, are the mechanism that triggers "runs" on banks, financial institutions, financial markets and firms. Such runs occurred throughout our history and again in 1966, 1970 and 1974/75.

Our economy is not a self-equilibrating system. Its essential path is cyclical. Some of the cycle downturns have big-bang properties that are associated with financial crises. These propositions differ from those of the standard economic theory — the theory of both monetarists and Keynesians — which holds that our economy is self-equilibrating and its basic path steady growth. Because standard economic theory cannot explain financial crises, it is a poor guide to economic policy for our economy.

If our economy is now crisis-prone, why haven't we had a full-blown financial crisis and deep depression since World War II? In particular, why didn't the sky fall in 1975?

The sky did not fall in 1975 because the Federal Reserve, the Federal Deposit Insurance Company and other regulatory bodies acted as a lender-or-last-resort and:

- Poured about $1 billion into a refinancing the Franklin National Bank.
- Validated all deposits in failed banks, not just the $40,000 statutory limit.
- Facilitated the refinancing of

seas deposits of U.S. banks was facilitated by the implicit guarantee from the Federal Reserve that emerged from the way Franklin National was liquidated.

The vast expansion of global dollars is one cause of the depreciation of the dollar on the foreign exchanges, and this is one cause of our inflation. The huge government deficit of 1975 has been followed by smaller, but still substantial deficits. Big government was a "blessing" when the thrust towards a financial crisis was aborted. It is a curse when inflation takes place during relatively good times.

The managing of money in an inherently unstable economy is not easy. It cannot be set out in simple rules. Banks and other profit-seeking financial institutions have developed many ingenious instruments which enable them to finance activity without issuing demand deposits and passbook savings accounts.

Even as attention has focused on the money supply, the banking system has evolved so that the bank liabilities that enter into the money supply are of lessened significance. Monetary policies which emphasize control of banks' reserves by open market operations may have had some power to control the tranquil economy of 1952-'66, but they have little power in the highly convoluted and fragile system of today, especially as the threat of a financial crisis leads to prompt lender-of-last-resort intervention by the Federal Reserve.

Techniques and rules for managing money that had some validity prior to 1966 will not do in the financially fragile and cyclically turbulent economy we now have.

To do better we should develop means of controlling debts. On the one side this means reforms of a myriad of laws and regulations which

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any use of debt to finance investment

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and positions in capital assets. Both the data and theory show that over a run of good tranquil years (such as 1952-'66) financial relations evolve, so that an initially robust financial system, in which a financial crisis is unlikely to happen, becomes fragile and crisis-prone.

This is so because over a run of good, calm years the risk premium that businessmen, bankers and investors attach to the use of debt to finance activity decreases. As a result of cumulative changes in the volume and composition of debt, the proportion of business, household and bankers' cash flows committed to servicing debt increases, and an increasing proportion of outstanding debt can be "paid" only if new debts are floated.

During good times the financial structure becomes more complex. New instruments — such as Federal Funds, commercial paper and certificates of deposits, new usages — such as "liability management" banking, and new institutions — such as money market funds and real estate investment trusts appear and spread in response to profit opportunities.

Mr. Minsky is Professor of Economics at Washington University, St. Louis. This article is taken from his testimony before the Joint Economic Committee of Congress. In it, he addresses himself to two questions: What causes instability and inflation in our economy? And can managing money by the traditional tools control or eliminate instability and inflation? His answers are that the inflation of the past decade has resulted largely from the way we have gone about preventing debt deflation and deep depression and that the lessons learned earlier about managing money are of little or no use in controlling the inflation and instability of late 1970s.

runs the increased supply available from institutional evolution and portfolio adjustments. This puts upward pressure on both short- and long-term interest rates. Higher short-term interest rates increase the cost of investment even as higher long-term interest rates depress the value of capital assets. This scissors effect decreases the pace of investment.

Liabilities are commitments to pay cash at dates or under conditions described in the contract. The needed cash can be obtained:

- From "operations."
- By rolling over (borrowing to pay) the principal even as interest payments are covered by income.
- Or by borrowing to pay both principal and interest on outstanding debt.

When receipts fully cover payment commitments, the unit is hedge financing. When borrowing is necessary to meet repayment of principal the unit is speculative financing. And when a unit needs to borrow to pay interest, the unit is Ponzi financing.

Both theory and data show that over the course of good times the ratios of speculative to hedge financing and of "Ponzi" to speculative financing increase. Non-fraudulent Ponzi finance takes place whenever long gestation investment projects are undertaken. But rising interest rates raise the costs of such schemes and lower the present value of the distant-in-time payoff.

High and sharply rising interest rates can transform hedge into speculative and speculative into Ponzi financing. As financial postures shift towards speculative and Ponzi finance (towards the use of short-term debt to finance long-term endeavors), the susceptibility of the economy to a crisis and the ability of within-the-system processes to trigger a crisis increases. Financial crises are normal results of the workings of our economy.

In a capitalist economy, if government is small, profits equal investment. Profits are the funds that validate business debts. Higher interest rates tend to cut investment, thus lowering profits. This lowers the ability of business to fulfill commitments on debts: the liabilities of what were hedge and speculative units become "workout" or Ponzi assets on the books of banks.

Deposit Insurance [illegible] other regulatory bodies acted as a lender-or-last-resort and:

- Poured about $1 billion into a refinancing the Franklin National Bank.
- Validated all deposits in failed banks, not just the $40,000 statutory limit.
- Facilitated the refinancing of REITs by commercial banks.

Furthermore, the Federal Reserve, as it validated Franklin National's overseas liabilities, implicitly extended its protection to all deposits in overseas branches of U.S. banks.

In 1975 the Federal Government threw a massive deficit at the economy. In the second quarter of 1975 the deficit ran at an annual rate in excess of $100 billion. Whereas in a small-government economy profits equal investments, in a big-government economy, profit equals investment plus the government deficit.

In the second quarter of 1975, even as unemployment rates were rising rapidly, corporate profits increased. Because of the huge government deficit, the ability of business to fulfill its financial commitments was not compromised as investment fell.

The seeds of our current inflation were sown in the turbulent days of 1974-75. The huge expansion of over-

Big government was a "blessing" when the thrust towards a financial crisis was aborted. It is a curse when inflation takes place during relatively good times.

encourage debt financing. To decrease the emphasis on debts, full employment rather than economic growth should become the proximate objective of policy. What is done to encourage economic growth is inflationary and tends to increase financial instability.

The rise in bank credit that was made possible by a rise in the asset/equity ratio of the giant bnaks has been a destabilizing influence over the past decade. Bank examination is effective in controlling this ratio for small and modest size banks but bank examination is ineffective in controlling giant banks.

To establish some Federal Reserve control over destabilizing credit expansion by giant banks, the Federal Reserve and the FDIC should have the authority to set ceilings on the asset/equity ratios of banks. ■

Gas Price Posting Called Cost Cutter

Posting gasoline prices prominently at service stations to they can be seen by passing motorists stimulates competition and results in savings to consumers, according to a new report published by the American Enterprise Institute for Public Policy Research.

The study, "Prices and Consumer Information: The Benefits from Posting Retail Gasoline Prices," states: "Consumer gains throughout the nation in 1975 due to price posting as intense as that in the Los Angeles area were estimated to be at least $322 million annually and possibly as much as $507 million annually.

"The simple act of price posting is associated with a retail price reduction of about 1-cent per gallon for leaded regular and 0.8 cent per gallon for leaded premium," the study reports.

Authors Alex Maurizi, a research scientist with Battelle Memorial Institute in Seattle, and Thom Kelly, an economist with the Energy Resources Conservation and Development Commission in Sacramento, base their findings on a survey of gasoline prices in 14 geographical areas, including six in California and four in the metropolitan New York City region.

The period used for the survey, Nov. 1970, was selected because it predated the wage and price controls imposed in August 1971, but the results have been updated to reflect present-day conditions.

The most revealing data came from a comparison of prices in the New York area, where less than 10% of the stations posted their prices, and Los Angeles, where 90% posted regular gasoline prices and more than 70% posted premium prices.