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'75 Depression Avoided Only By U. S. Spending, Role as Ultimate Lender

By HYMAN P. MINSKY

Why didn't the sky fall in 1975?

During the fourth quarter of 1974 and the first quarter of 1975 there was a precipitious drop in economic activity, a wave of bankruptcies, and an epidemic of precarious financial positions. The dispersion and depth of financial difficulties indicated to many that a financial crisis was imminent.

The dreary data and the ominous financial news of the first quarter of 1975 made it seem as if another Great Depression—such as occurred in the 1930s—was about to hit.

In the second quarter of 1975 the apparent free fall of the economy was sharply braked. By midyear 1975 a recovery, at times quite vigorous, was under way. Although residues of the critical financial situation of 1974–75 were still evident, by midyear 1976 it became apparent that financial markets and institutions were resilient. No cumulative debt deflation and deep depression has taken place; the financial shocks of 1974–75 were absorbed and "damped out."

The events of 1974–75 are not isolated episodes of incipient financial crisis and an associated "recession." The events of 1974–75 were the third such episode in the U.S. in less than a decade. The prior credit crunch of 1966 and the Penn-Central commercial paper "liquidity squeeze" of 1970 were prior episodes. All these near financial crises occurred when Federal Reserve operations which conformed to conventional anti-inflationary guide-

as the REITs), and business borrowing from finance companies is indicative of the increased fragility of the financial system.

The above have in common a dependence upon borrowing in order to repay debt. Once the economy's normal functioning is not expected to generate enough cash to repay a large proportion of outstanding debts but, instead, the funds to repay these debts will have to be raised by borrowing (refinancing), then the financial system is fragile.

Pundits, politicians, and officials have been proclaiming that we got out of the "near crisis" and the recession of 1973–75 as a result of the normal functioning of market processes. In truth the emergence of an incipient financial crisis and the free fall of the economy in late 1974 and early 1975 led to strong fiscal measures and prompt lender-of-last-resort interventions. The braking of the downswing and the subsequent recovery is largely due to these actions.

The fiscal measures were in part automatic, because of massive entitlement (transfer - payment) programs and a tax system which falls behind expenses when income and employment declines. In addition positive fiscal measures like tax rebates, tax reductions, and extensions of unemployment insurance helped brake the decline.

The standard economic analysis of the impact of government, which only looks at how gross national product is affected, misses the full impact of government in our economy. The full significance of government spending and taxing is revealed only when fi-

Thus the sky did not fall in '75 because:

- Big government, and the associated massive deficits affected income, sustained the viability of private financial commitments, and improved the composition of portfolios.
- Federal Reserve and cooperating private and public bodies aptly executed lender-of-last-resort functions.

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Quite clearly the percipitious drop of 1974IV and 1975I was linked to the difficulties of Franklin National Bank, the REITs, a gaggle of firms, and a parade of municipalities. The first necessary step of policy in such an emerging financial crisis is to prevent the financial difficulties of one unit from causing financing difficulties for other units. This is what lender-of-

By 1965 the financial structure of the U.S. economy was significantly more fragile than in 1946, and by 1974 was noticeably more fragile than in 1965.

last-resort activity endeavors to do and this was successfully accomplished in 1975.

True there was an increased wariness on the part of lenders. Contagion from the difficulties of some firms, utilities, and municipalities affected the market price of liabilities of all firms, utilities, and municipalities. Financing costs went up for many units because credit ratings deteriorated even as "prime" market rates went down.

Nevertheless no depositor in the banks that failed and no significant set of holders of REIT commercial paper was forced to take a loss.

Financial difficulties preceed and trigger the sharp drop in income. Too much should not be made of the simultaneity of the beginning of the deep plunge in 1974IV and the closing of

and the dependence upon military expenditures for the purchase of goods and services—has serious side effects in that it makes our economy susceptible to strong inflationary pressures. Both military spending and transfer payments involve the generation of disposable income without any offset of useful civilian output.

In addition we try to run a technologically sophisticated economy in which debt financed private investment is a leader in determining income. Capital-intensive investment is favored in our tax laws as well as in our standard view of how our economy works. But such investment implies that ever larger proportions of income has to be allocated to validating past investment and to pay commitments on debts.

A commitment to technically sophisticated capital intensive modes of production in a capitalist economy means that the tendency towards financed instability is accentuated. Furthermore inflation facilitates the fulfillment of debt contracts fixed in nominal terms. An economy which emphasizes investment functions better with an inflationary bias.

Thus we have achieved a solution, but not the only possible solution, to the problem of deep depressions in a capitalist economy. The solution we have achieved has two serious flaws: one is that it leads to cyclically rising inflation rates and the other that it leads to frequent threats of debt deflations and deep depressions.

Although we came off well enough in 1973-75, there is always the possibility that government will not be big enough or the lender-of-last-resort actions will be inept so that the decline is greater and the trough of the recession/depression is wider than we have experienced recently.

Of course an economy need not emphasize capital-intensive techniques and investment and we need not rely upon transfer payments to make government big. Instead of an investment-transfer payment policy strategy we can have consumption-employment strategy. A key element

Although inflation and interest rates were higher in the past decade than earlier in the postwar era, prior to the 1960s Federal Reserve constraint to halt inflation had not triggered a near financial crisis. The financial environment within which the Federal Reserve operated in 1965-75 differed in critical ways from the environment immediately after World War II. Over the postwar era the financial system evolved so that it now is more susceptible to financial crises.

The susceptibility of a financial system to a crisis is determined by where the financial system lies on a robustness/fragility scale. By 1965 the financial structure of the American economy was significantly more fragile than in 1946, and by 1974 the financial system was noticeably more fragile than in 1965. This thrust towards financial fragility is the result of "inside the system" destabilizing factors which cumulate to change the character of the financial system.

The basic determinant of the fragility of a financial system is the extent to which short-term debt finances holding of capital-assets, holding of financial assets, and investment. The growth in importance since World War II of commercial paper financing, liability management banking, specialized financing institutions (such

Dr. Minsky is professor of economics at Washington University, St. Louis. This article is excerpted from a paper he prepared for the Graduate Institute of Cooperative Leadership at the University of Missouri, Columbia, Mo. In it, he says that the reason the 1974–75 recession didn't turn into a deep depression of the 1930s style had nothing to do with the workings of a market economy. Disaster didn't occur—the sky didn't fall in—because government spending and government's role as lender of last resort combined to prevent the fall. But, he says, such activity by big government has made us vulnerable to inflation and increased the destabilizing tendencies in the economy.

The huge government deficit prevents an induced decline in income from taking place as business decreases investment spending to improve balance sheets

nancial repercussions are also taken into account.

In an economy with a large volume of private debt, a large government deficit during a recession assures that business profits and household savings will be sustained even as output and employment falls.

Another financial effect of a big government is that the "bonds" issued to finance large deficits must show up as a significant increase in safe assets in the portfolios of businesses, households, banks, and other financial institutions. The financial repercussions of "big government" make it possible for private debtors to fulfill commitments and for improvements in the safety and liquidity of portfolios to take place in a recession.

The income and financial stabilizers due to big government take time to become effective. Meanwhile financial business profits and household savings ments on outstanding short term debts and declining asset values, threaten to turn financial tautness into a financial debacle. To prevent an incipient financial crisis from becoming a fullfledged crisis, refinancing activity by the Federal Reserve and cooperating private and public organizations is needed.

Such refinancing, or "lender-of-last-resort," activities were carried out by the Federal Reserve System, The Federal Deposit Insurance Corporation (FDIC), and private financial institutions, such as commercial banks and insurance companies, in the 1973–75 recession.

tainly increased the awareness in financial and business circles of exposed financial postures. This quite naturally led to defensive behavior—which implies a decrease in debt financed spending.

The aborting of a financial crisis and the prevention of contagion from one taut financial position to another comes first in the sequence of interventions that halts and then reverses a plunge of the economy. The ability of banks—with the cooperation of the regulatory authorities—to carry walking bankrupts and to restructure weak financial positions is a critical element in easing a cumulative decline.

The "big government" stabilizer only comes into play as or after income falls; the lender-of-last-resort functions come into play from the earliest stages of the decline.

Once the feedback by way of an exploding government deficit to household savings and corporations gross profits occurs, then the threat of a financial crisis is eased. This is so because the increase in corporate gross profits implies an increase in the debt carrying capacity of the corporate sector as well as an increase in the value of capital assets.

If the initial shock of events, such as the failure of a giant bank or the public difficulties of a major corporation, leads to a reconsideration of the desired liability structure of business, then the increase in cash flows that occurs as an offset to government deficits will improve the liability structure of business without requiring a cut in spending or new investment. The huge government deficit, such as emerged in 1975, prevents an induced decline in income from taking place as business decreases investment spending in an effort to improve balance sheet positions.

Thus we now have a "technique" for preventing debt deflations and deep depressions. This success is not a free good. The particular way in which our government is big—the massive transfer payment schemes

payments schemes and a substitution of "open" or "tap" W.P.A., C.C.C., and N.Y.A. employment schemes.

That is, the "work" programs of the 1930s would be revived to replace

The emergence of an incipient financial crisis in late 1974 and early 1975 led to strong fiscal measures and prompt lender-of-last-resort actions.

the massive transfer payment programs. Simultaneously with the introduction of W.P.A., C.C.C., and N.Y.A. a reform of taxes would be undertaken to remove the bias in our tax laws against labor intensive and in favor of capital intensive techniques of production.

If the elimination of deep depressions is the sole objective of policy, then our big government/lender-of-last-resort policy mix is successful and we now have a good economic society. If the oscillation between accelerating inflation and threatened deep depressions means that this economy is inefficient and inequitable, then perhaps we have to accept the degree of inefficiency and inequity that now exists in order to avoid the tragedy of a great depression.

However there are alternatives. Government must remain big but the "transfer payment" route is not the only way to go. There is an alternative which can ease the inflationary thrust and decrease the tendency toward unstable financial postures. This other way, the consumption/employment route, however involves thoroughgoing reform of the economic structure that grew up over the past 40 years—a structure that has kept the sky from falling to date in the post-World War II epoch. ■