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An Economic Appraisal

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Standard Forecast Questioned

By DR. HYMAN P. MINSKY
Professor of Economics
Washington University
St. Louis

An economist who examines both financial and economic forces at work in the U. S. economy today must take issue with the standard forecast. He concludes the second half, 1974 may be weaker than the first half, not stronger. And he also concludes that rather than a very strong recovery in 1975, as suggested in this column recently by Dr. Burress, chairman of the board of contributing economic editors of the Journal and a professor at the University of Texas of the Permian Basin, 1975 is likely to be a year of stagnation.

I do not disagree with Dr. Burress' new theories of the role of the consumer in fluctuations in the economy. Indeed much of the recent work he did in that area was here in our Dissertation Workshop in Macroeconomics at Washington University while he was a guest faculty member. I applaud his work.

Powerful Forces at Work

But Dr. Burress, and to a greater extent, most of his economic brethren, most especially those who prepared the 1974 Economic Report of the President, fail to see the powerful forces that are making the financial system of the U. S. economy increasing fragile, and therefore making the economy increasing sensitive to even minor shortfalls from that level of GNP required for full employment. And 1974 is surely one of those years of shortfall of GNP below the full employment level.

This line of reasoning, which I reported to the Commission on Money and Credit mor than a decade ago, is based on close examination of the data, not only since World War II, but data which span nearly a century. There is a continuity between the pre-Depression days and post-World War II period. But recent data on the increasing fragility of the financial system since world War II demonstrate increasing cause for alarm. Those data appear to question the popular assumption that there can never be another great crash, although that is not what is suggested for the second half of 1974 and 1975.

The council's forecast for the first half of 1974 should be taken more seriously than its forecast for the second half. They give proper weight to uncertainties due to the oil embargo that has since been lifted for a period that is still uncertain. In short, their forecast for the first half is based primarily on observations. But the forecast for the second half is based on standard economic theory.

The school of economic economists to which the council members belong believes deviations of the economy from a stable, noninflationary growth path are mainly due to prior disturbance originating outside the internal workings of the economy. They further believe that if no further outside disturbances occur, such as an oil embargo, and especially, if monetary and fiscal policy are not disruptive, then the economy will quickly return to its normal growth path.

But this approach totally neglects the fact that the slowdown comes at a time when the financial system, by carefully constructed measures, is substantially more fragile than at any time in the postwar era.

And this explains, in part, why economic theory underlying the council's forecast is under serious attack from economists who hold that "good times", or noninflationary growth, are a transitory, not a normal, state of the economy.

Stability Destabilizing?

These other economists hold that financial and wage price processes tend to move the economy away from self-sustaining, stable noninflationary growth. In these economists' views, stability is in and of itself destabilizing.

Here at the Dissertation Workshop we emphasize data on the financial structure of the economy that are ignored by the standard school which underlies the council's forecast.

American economic history from the birth of the Republic to the great Crash of 1929-33 is replete with financial crises. Between the Depression of the 1930s and 1966 no events remotely resembling a financial crisis occurred. The credit crunch of 1966 and the Penn Central-commercial paper market developments of 1970 were miniature financial crises. In both instances prompt action by the Federal Reserve prevented the initial distrubance from triggering a full-fledged financial crisis. Even so these mini-crises led to slowdowns of the economy — a pause in 1967 and a recession in 1969-70. Furthermore, the actions taken by the Federal Reserve to abort a possibly serious crisis had the unwanted side effects of setting the stage for a renewed inflationary thrust.

Detailed data about the financial structure of the American economy appear in the Federal Reserve's Flow of Funds accounts. This information about income flows, assets, and liabilities for various sectors is now available for the entire period since the end of World War II. From the data in the Flow of Funds accounts, it is possible to construct indices which measure the relative fragility of the financial structure.

Fragility of System

The relative fragility of the financial system can be estimated by looking at the cash flows of households and nonfinancial corporations relative to their debts, and at the relation between liabilities and secure financial assets for various sectors. By all these measures, there has been a sharp increase in the fragility of the financial system between the end of World War II and the time of the credit crunch in 1966. For many measures this trend points to increased fragility since the 1966 crunch.

For the nonfinancial corporate sector the ratio of liabilities to gross profits after taxes stood at 5.6 in 1949. This rose to 6.3 in 1966 and stood at 8.5 at the end of 1972 (the latest date for which Flow of Funds balance sheet data is available). For households the ratio of liabilities to dis-posable income rose from .34 in 1949, to .73 in 1966 and has remained at or above .73 since 1966.

It is clear that the danger that firms and households may not be able to fulfill contractual obligations out of cash flows, if profits are sharply cut or if unemployment is prolonged, is now substantially greater than earlier in the postwar period.

An alternative to paying debts out of cash flows is to pay debts by drawing down on cash or marketable financial assets, which could induce gross financial dislocations on Wall Street. For the nonfinancial corporate sector the ratio of liabilities to the sum of demand deposits, time deposits and Federal Government debt rose from 2.7 in 1949 to 7.1 in 1966 and stood at 10.4 in 1972. For households the ratio of liabilities to the sum of Federal Government debt and deposits at banks and savings institutions was 3.4 in 1949. By 1966 this ratio rose to .76 and it stood at .72 in 1972.

Thus for both nonfinancial corporations and households, the fragility of the financial system, as measured by assets which can be drawn down to meet debts, is now substantially greater than at the end of World War II and somewhat greater than in 1966.

System More Fragile Now

Data on the financial sectors also indicate that the financial structure is now more fragile than earlier in the postwar period. Commercial banks are the heart, and presumably the most secure portion of the financial structure. Over the postwar period, the ratio of no default assets (cash plus Treasury securities) to total assets in the portfolios of commercial banks has fallen from .61 in 1949 to .16 in 1972 and the ratio of purchased money (negotiable certificates of deposit, Eurodollars, and federal funds) to total assets has risen from .03 in 1949 to .19 in 1972. These trends within commercial banking have been accompanied by a large growth in fringe financial markets such as the commercial paper market and the real estate investment trusts.

The above is but a small sample of the data which indicates that the financial system is now substantially more fragile than it was earlier in the postwar period. Although this greater fragility does not guarantee that a financial disturbance will occur, it certainly indicates that there is a clear danger that one might occur. The possibility cannot be ignored that the downturn in income in 1974 may trigger financial dislocations not unlike those of 1966 and in 1972.

In these prior mini-crises, the Federal Reserve acted promptly to offset the destabilizing movements, they succeeded in aborting the incipient serious financial crisis. However, the Federal Reserve has been blamed for the later inflationary bursts. This may now make the Federal Reserve less prompt in responding to a threat in 1974 than it was earlier.

In any case, regardless of whether the Federal Reserve responds promptly or with a lag, the development of even a mini-crisis during 1974 will assure that the second half of 1974 will be worse not better than the first half — and that at best 1975 will be a year of stagnation.