The Coming Economic Crisis

Collapse Of Major Financial Houses More Likely Than At Any Time Since '30s

By Hyman P. Minsky

The recent signs of financial weakness cannot be disregarded. In October 1984, the flight of offshore deposits triggered the collapse of the Continental Illinois Bank. In March 1985, the failure of a minor government bond house in Florida led to the closing of all of Ohio's state-insured savings institutions and a break in the foreign exchange market that knocked some 10 percent off the international value of the dollar.

If we combine these events with the sharp decline in the price of agricultural land, the treasured value of much of commercial real estate, the explosive increase in business debts due to corporate takeovers and merger plays, and the still unresolved problems of Latin American debts, it is clear that the margins of safety in financial relations are greatly diminished. A major shock effect collapse of financial institutions and asset values is much more likely now than at any time since the 1930s.

The financial developments together with the lackluster Reagan prosperity, which is unable to bring unemployment below the 7 percent mark, raise concerns about the true nature of our economy that have not been addressed since the Great Depression. Is our economy inherently stable? Is there a close approximate to prosperity its normal state? Is it unstable? Do its internal shocks from time to time lead to a serious depression?

These questions are addressed by the financial instability hypothesis, a variant of Keynesian economic theory, which holds that over an extended period of good times profit-seeking actions of bankers and businessmen lead to the financial system evolving so that it becomes a habitable environment for an interactive (demand effect) financial crisis. Such a crisis can usher in a serious depression, but it need not. Leaders of last-resort interventions by the monetary authorities and the deficits of big government during a recession can contain a financial crisis and quite quickly induce a recovery. The hypothesis also holds that inflation usually follows these interventions.

The course of the economy during the Reagan years closely continues to the financial instability hypothesis. The success in reducing inflation can be linked to the international strength of the dollar, high unemployment rates and the decline in union strength.

We are now approaching the two-and-a-half year mark of the current expansion. Normally we would expect the expectation and equipment for such exploration — their oil losses are likely to be compounded by real estate losses. It is known that there is sizable inventory of commercial property in the major cities. If the price of oil, the price of oil exploration and the market value of rigs suffer another decline, then the inventory of vacant commercial property in the cities that are closest to the oil industry is likely to increase. This will lead to the overt recognition of losses in real estate, first in the impacted cities and then throughout the economy.

Over the past 18 months the dollar has been appreciating rapidly and there has been a large increase in dollar-denominated offshore banking. These offshore banks have dollar assets and liabilities and maintain a position in 'New York dollar assets' in order to meet clearing losses (New York dollar assets are their reserve currency). If the current decline in the dollar continues, it will be because various forms of hot money move out of the dollar and into other currencies. When this happens these offshore dollar banks will need to sell off their New York assets to buy the other currencies.

A modest orderly decline in the dollar might be welcomed by the banking authorities. However, a decline in today's markets is not likely to be modest or orderly; at some point a runout of the dollar will occur. When this happens the Federal Reserve, as in 1973, will need to push interest rates up in order to protect the international position of the dollar.

A rise in interest rates to the levels of 1980-82 will play havoc with the ability of highly indebted businesses and households to fulfill their payment commitments; this will put pressure on the liquidity and solvency of already weakened banks.

The various plays that lead to mergers, takeovers and buy-outs involve the use of debt — fancy money, junk bonds and bank loans. For each newly highly indebted organization that results from these plays, there is a maximum set of interest rates that it can tolerate. Any scenario that leads to substantial higher interest rates will see some of these deals unraveling.

Given the big and still increasing government, any decline in national income will lead to a large increase in the deficit. As a result, the system will not collapse, as in 1929-33, but bankruptcies and the number of asset values that plunge are likely to exceed what happened in 1981-82. The income and employment declines and the breadth and depth of the financial trauma of the next recession will likely exceed that of 1974-75 and 1981-82, even if the Federal Reserve interventions and the rise in the federal deficit take place quickly. But if the Federal Reserve and the Treasury hold back, either because they are fighting inflation or because of their ideology and economic theory, then a second Reagan recession can become the Reagan depression.