

INTEREST RATES IN OUR UNSTABLE ECONOMY

By

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**Remarks prepared for Fourth Institutional Investor Bond Conference
October 12, 1976
New York City**

Upon being told that Clement Atlee was a modest man, Winston Churchill is reported to have remarked that "Mr. Atlee has a great deal to be modest about." The poor performance of economic forecasts and policy since the mid-1960s means that economics, as a discipline, has "...a great deal to be modest about." Economists who use standard theory have done so poorly that the validity of the theory they use must be questioned.

Two "standard brands" of economic theory - standard Keynesian and monetarist - have dominated the market. As is often true in oligopoly markets, these dominant brands are really very much alike. In spite of differences in econometric garb - standard Keynesian go in for large scale structural models and monetarists use small scale reduced form models - both standard brands rest upon the same economic theory, the "neo-classical synthesis".

It is evident that this "neo-classical synthesis" won't do for our economy in our time. Both monetarist and standard Keynesian theory are designed to deal with equilibrium and equilibrating tendencies, whereas our economy has been increasingly unstable. Three progressively more serious financial trauma, recessions, and critically disruptive movements in interest rates and asset prices have taken place since 1966. Such unstable behavior is foreign to the neo-classical synthesis. Standard economists can offer no satisfactory explanation of what happened. We need to understand why interest rates exploded in 1973 and why a debacle nearly occurred in 1974/75.

In order to do better economists must abandon standard theory and develop an alternative line of thought that pays attention to the institutional detail and disequilibrating relations of our economy. Such an alternative is emerging in what is now called "post-Keynesian" theory. The particular version of "post-Keynesian" theory that I will apply here emphasizes the financial relations of a

capitalist economy. This Keynes theory shows that strong endogenous destabilizing processes exist in an economy that is capitalist, uses capital intensive production techniques, and is financially sophisticated; i.e., our type of economy is inherently unstable.

There is another shortcoming to today's standard economics. Over the past thirty years economists have had a romance with econometrics: The cloth of economic analysis has been cut to fit the capabilities for econometric computation. Institutional and evolutionary characteristics of the economy have been neglected. Economists have been granted degrees and turned loose to practice who neither know nor care about economic institutions, their evolution, and how institutions and usages affect market conditions. As a result many modern economists tend to ignore what happens when businessmen and bankers make deals and the forecasts that failed reflect this ignorance.

The money supply is a financial variable that can be readily modeled as a function of known ratios, the availability of reserves, and observable market variables. This makes models which use the supply of money and Federal Reserve operations as "tune callers" comparatively easy to handle econometrically. Because econometricians are skilled in massaging and mining data and in adjusting the structure of models, results which satisfy econometric tests are obtained for models that use the supply of money as the "tune caller." Because so many things in an economy move along together these econometric models are good enough to serve in an age of tranquility. In an age of rapid institutional evolution and speculative financial interactions, these models fail.

The same phenomena, validity in an age of tranquility and loss of power in an age of instability, is evident for the more complex structural models used

by standard Keynesians. Because simplistic slogans, derived from obsolete monetarist studies, seem to affect current policy, my emphasis in what follows will be upon monetarist rather than upon standard Keynesian views.

Money and other financial instruments are created as a result of transactions by profit seeking businesses. In a business loan the borrower exchanges debt for money in order to finance a position in some type of asset. The borrowers hold that the cash today-cash tomorrow relation for the asset in position is better than for the debt. The use of debt to finance positions in financial and capital assets is a pervasive attribute of our economy.

Outstanding debt embodies payment commitments by debtors. Our economic system can be characterized by the inherited maze of cash payment commitments on outstanding contracts and by the sources that units expect to use to acquire the cash needed to meet these commitments. In our type of economy there always exists some debt that will be paid by the proceeds obtained from new debt. The relatively robustness or fragility of a financial structure is affected by the extent to which payment commitments are expected to be met by rolling debt over. In particular the demand for funds to roll over outstanding debt constitutes a very inelastic portion of the demand for financing.

The development and growth of specialized financial institutions (such as REITs) of money market instruments (such as commercial paper) and of liability management banking represent an increase in the proportion of outstanding debt that can be paid only by rolling over debt. The relative growth of market oriented financial intermediation leads to ever higher inelastic financial components to the demand for short term financing.

Short term debt is normally used to finance investment, during their gestation period, and inventories. Investment projects are often complex, involve

significant gestation periods, and lead to a precise and predetermined sequence of payment commitments that are fixed when the investment project is started. The excess, during any period, of investment over the flow of internal funds to business constitutes a very inelastic demand for external financing. If, as happened in the early 1970s, the excess of business investment over business internal funds is large and increases rapidly over a number of years, a cumulative, rapidly rising inelastic demand for short term financing emerges, especially if long term debt financing becomes expensive.

Inventories are also financed by short term debt. Inflation results from an increase in investment demand as a proportion of total demand. An investment boom leads to increased quantity and prices of inventories. A rise in the demand for short term financing occurs whenever inventories increase and prices rise.

The market demand for short term financing depends upon the history of the economy. If this history had led to a large proportion of money market financing of positions in capital and financial assets, a large excess of capital investment over corporate cash flows, inventory accumulation, and price inflation then the demand for short term financing that will result will be rising and increasingly inelastic.

If an interest inelastic supply schedule of funds is confronted with a rising and inelastic demand for funds a sharp rise in interest rates will take place. The supply of funds for external financing depends upon savings flows, the use of cash balances to acquire financial assets, and the rate of growth of bank financing because of money creation. After fifteen years of slow but steady changes in financial markets, the 1960s saw an acceleration of changes in financial usages. The explosive growth of commercial paper, certificates of deposit,

liability management banking, and money market oriented intermediaries such as REITs in the late 1960 and early 1970s used cash balances to make short term funds available to finance positions in assets. Over this decade the articulation of cash payments to cash receipts became ever closer and the dependence of income, employment, asset prices, and interest rates upon the continuation of tranquil financial markets in which outstanding debts could be readily rolled over increased.

In the early 1970s the rising and inelastic demand for funds outpaced the growth of the supply of funds due to the "activation" of idle balances and the increase in the money supply. Under these conditions a sharp run-up on interest rates took place. This run-up of interest rates increased the completion price of investment in process and led to the use of on hand liquid assets to repay debts.

Borrowing and lending takes place on the basis of margins of safety. Three margins of safety can be readily identified: a standby reserve of cash and near cash, an excess of cash flow receipts over contractual payments, and an excess of present value of assets over debts. When rising and inelastic demand for finance is confronted by an inelastic supply schedule interest rates tend to rise rapidly. This induces the use of cash on hand and marketable financial assets in lieu of borrowing and strips units of liquidity. The higher interest rates on debt decreases the cash flow margin of safety due to capital-assets and fixed term financial assets receipts so that units lose on the carry. As the rise in short term rates induces increases in longer term rates, the present value of items in the stock of capital-assets falls below the completion cost of investment goods in the production pipeline. All three margins of safety are

adversely affected. Under these circumstances the ability to pay debt by issuing new debt disappears: financial markets become disorderly.

Although disorderly financial markets have ushered in the great depressions of history, we now know that quick and decisive lender of last resort actions by the central bank, in the context of a government that looms large in the total economy, can abort the debt-deflation and sustain a high floor to income. In the context of central banking which absorbs losses, as the Federal Reserve and F.D.I.C. did in the Franklin National and other failures, and a government which feeds enormous amounts into disposable income through transfer payments whenever income falls, financial instability does not lead to a great depression. It does lead to the type of instability we have witnessed over the past decade. Government intervention and central banking have not eliminated business cycles; they have changed the shape.

In the brochure, the question posed for this session was "When will interest rates peak?". Since the brochure was prepared interest rates have trended downwards. The question that was asked represented the thinking of the time the brochure was printed. If the relation between corporate investment and corporate cash flows, the balance sheet of banks, and developments in the position financing of intermediaries had loomed large in the analysis of interest rates when the question was asked it would have been recognized that basic financial market conditions were not conducive interest rate increases. The interest rate increases of April and May of 1976 were the result of poorly conceived Federal Reserve behavior. The current slowdown in the expansion may very well be the result of an emphasis in Federal Reserve policy determination upon money supply targets rather than upon underlying economic conditions.

As we look to the fourth quarter of 1976 and the first quarter of 1977 the expected investment/cash flow situation is more conducive to falling than to rising interest rates. Interest rates can be made to increase if the Federal Reserve decreases and tends to make inelastic the supply curve of finance. Such tightening is not called for by existing and expected employment, price, and output relations. The efforts of banks to remain fully invested may very well lead to short term and transitory increases in the money supply that fall outside the guidelines set by the Federal Reserve. If the Federal Reserve reacts to these increases by acting to decrease the supply and elasticity of finance, it can make interest rates increase. These increases will not be warranted by expected employment, price, and output relations. If the Federal Reserve acts to constrain the supply of finance in the next six months it will be guilty of making policy while wearing the blinders of a theory that has little relevance to the world in which we live; it will be responsible for increasing the instability of an already unstable economy.

To summarize today's standard economic theory is not capable of explaining what happens in our type of economy. Thus the rules for economic policy derived from these theories are not valid for our economy. If the Federal Reserve looks at the "correct" evidence we should see lower interest rates over the next six months. If, on the other hand the Federal Reserve persists in following a money supply rule our current limping expansion may be "choked off" by inept Federal Reserve actions.