INTEREST RATES IN OUR UNSTABLE ECONOMY

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by financing a position in assets. Debt embodies payment commitments. Our economy can be characterized by the maze of payment commitments on contracts and by the expected sources of the cash that units need to meet their commitments. There is some debt that will be paid by the proceeds of new debt. The relative robustness or fragility of a financial structure depends upon the extent to which payment commitments are met by rolling debt over. 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 increased the proportion of outstanding debt that can be paid only by rolling over debt. Over the past decade these developments led to an ever higher inelastic financial component to the demand for short term financing.

Short term debt is normally used to finance investments during their gestation periods and inventories. Complex investments with long gestation periods lead to a sequence of payment commitments that are fixed when the investment project is begun. The excess, during any period, of investment over the flow of internal funds to business constitutes a very inelastic demand for external financing. In the early 1970s the excess of business investment over internal funds became large and increased rapidly. This led to a cumulative, rapidly rising inelastic demand for short term financing.

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 and a rise in the demand for short term financing.
The demand curve for short term financing depends upon the history of the economy. The existence of 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 means that the demand for short term financing will be rising and increasingly inelastic.

If a rising and increasingly inelastic demand for funds confronts a rising and interest inelastic supply schedule of funds then a sharp rise in interest rates will take place. The supply schedule of funds depends upon savings flows, the activation of cash balances, and the growth of bank financing due to money creation. An explosive growth of commercial paper, certificates of deposit, liability management banking, and money market oriented intermediaries such as REITs began in the 1960s. These developments increased the short term funds available to finance positions. The stability of income, employment, asset prices, and interest rates became ever more dependent upon the maintenance of tranquil financial markets in which debts could be readily rolled over.

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. As a result a sharp run-up of interest rates took place.

Borrowing and lending takes place on the basis of three margins of safety: (1) a standby reserve of cash and near cash, (2) an excess of cash flow receipts over contractual payments, and (3) an excess of the present value of assets over that of debts. All three margins of safety are adversely affected by rapidly rising short term rates. Rapidly rising short term rates
induces the use of cash on hand and marketable financial assets in lieu of borrowing, decreases the cash flow margin of safety by increasing the carrying costs for assets, and, by inducing increases in longer term rates, lowers the value of completed investment goods below the cost of producing investment goods. With margins of safety eroded the ability to pay debt by issuing debt diminishes: 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 combined with a government that looms large in the total economy, can stabilize financial markets and sustain a high floor to income. A central bank which socializes losses, as the Federal Reserve and F.D.I.C. did in 1974 and 1975, combined with a government which sustains disposable income through tax cuts and transfer payments mean that financial instability does not lead to a great depression: It leads to inflationary booms alternating with threats of depressions such as we had in the past decade. We have not eliminated the processes that make for business cycles, but we have changed the shape of the business cycles.

In the brochure the question posed for this session was "When will interest rates peak?". Since the brochure was prepared interest rates have fallen. The question that was asked represented the thinking of the time the brochure was printed. If the institutional relations governing the behavior of financial markets had loomed large in the analysis of interest rates, then those asking the question would have recognized that basic financial market conditions were not conducive to interest rate increases. The interest rate increases that took place in April and May of 1976 were the result of poorly conceived Federal Reserve behavior. The slowdown in
the expansion may very well be the result of Federal Reserve policy being
determined by monetarist rules rather than upon underlying economic conditions.
Borrowers and lenders, having just been hurt by high and rising interest
rates, quite rationally extrapolated the moderate increases of April and
May into signals that they better not make deals unless the underlying cash
flows could support 1973/74 interest rates. In this way the Federal Reserve
attenuated the recovery.

As we look to the fourth quarter of 1976 and the first quarter of 1977
underlying market conditions are conducive to falling interest rates. If
the Federal Reserve decreases and tends to make inelastic the supply curve
of finance then interest rates can rise. Such a rise is not called for by
the existing and expected state of the economy. Bank efforts to make profits
may lead to transitory increases in the money supply that exceed the guide-
lines derived from monetarist arguments. If the Federal Reserve reacts by
decreasing the supply and elasticity of finance, interest rates can increase.
These increases will not be warranted by economic conditions. If the Federal
Reserve acts to force interest rates up in the next six months it will be guilty
of making policy while wearing the blinders of a monetarist theory that has
little relevance to our economy. The Federal Reserve will be destabilizing
an already unstable economy.

Because neo-classical theory cannot explain what happens in our economy,
it cannot set the rules for effective economic policy. If the Federal
Reserve looks at financial market and economic conditions, interest rates
will fall over the next six months. If the Federal Reserve follows a re-
strictive money supply rule our current limping expansion may be fully
"choked off". Inept Federal Reserve policy can make 1977 another year of
recession.