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Recession - But Not Depression - In Offing, Part 1

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THE ECONOMY

from the not-so ivory tower

Recession—but not depression—in offing

By Hyman P. Minsky

Not all gestation periods are nine months. In the Great Depression of the 1930s, the event that was analogous to the market decline of October 1987, took place in October 1929. The climactic events of the Great Depression—the utter collapse of the banking system and the well nigh complete stoppage of the economy—took place in February 1933. The gestation period of the Great Depression, the time between the conception and the full flowering, was forty months.

Several years need to pass before the full effects are known of the crash of the nineteenth of October and the yo-yo behavior of the stock market that followed. The wiping out of some $800 to $1,000 billions of asset values on the American exchanges reinforced recessionary tendencies but it did not make a depression or even a recession inevitable. The evidence from the past two decades is that apt policy can contain recessions.

A recession is likely to start in either the fourth quarter of 1987 or the first quarter of 1988. If the scale of the recession is contained by apt policy, which makes credit readily available and sustains aggregate profits through a larger government deficit and a smaller trade deficit, then the events of the second half of October will go down in history as a correction rather than as the beginnings of a collapse. The events of 1987–88 will be interpreted as further evidence of the resilience of modern capitalism, that the economy is self-correcting.

On the other hand, if over the next six months the aftermath of the crash of Monday Oct. 19 includes failures of significant banks and other financial institutions any place in the world (or even of some of the conspicuous players in the international takeover and merger games), then the recessionary forces will be reinforced and the likelihood of a major contraction will increase. Before a major contraction can take place, the weaknesses and turbulences will have to spread from the security markets to institutions.

The catastrophe of 1929–33 was the result of institutional weaknesses, policy errors, and the internal dynamics of a capitalist economy, by which market reactions to an event like the stock market crash makes things worse. Intervention is needed to control market reactions from time to time if a catastrophe is to be avoided.

The policy errors during the Hoover presidency reflected administration ignorance of how our type of economy works. As a result of their ignorance, they depended upon the assumed self-correcting features of markets, which even if they exist were too weak for the great depression.

Because the Keynesian revolution in economic thinking greatly increased our knowledge of how capitalism works and developed a logic for intervention, we have to expect that Hoover-like errors will not be made now. However, we should never underestimate the ability of the political leadership of capitalist countries and their economic advisers to do the wrong thing: to take steps that make a bad situation worse. Political leaders wear blinders that reflect a market-oriented ideology and their advisers wear blinders that were crafted in graduate school, where they learned the conventional economic theory which emphasizes the self-correcting feature of markets.

The initial policy response to the crash of Oct. 19 was apt: the Federal Reserve increased bank reserves and intervention to prop up the dollar was abandoned: the dollar is being allowed to fall against the Yen and the Mark. The fall puts pressure on the exports of Japan, Germany, and those countries whose currency is tied to the German mark. Presumably, this will force them to lower interest rates and to engage in fiscal measures (lower taxes or increase spending) to expand domestic demand to offset the loss of jobs and profits that will occur as they are priced out of the American market. The current situation is different from that of the prior recessionary periods of the post World War II era. Whether a serious world recession occurs will depend at least as much upon the aptness of Japanese and German policies as upon those of the United States. The balance of world economic power is changing.

If the decline of the dollar corrects the United States's trade deficit and if Japan and Germany take measures to prevent any serious decline in their economies (and therefore in the world economy), then the large drain of profits from the United States by way of the trade deficit will diminish or even be reversed. If this occurs, United States profits will increase and any recession induced by the stock market crash will be contained. An expanding American economy with its international trade accounts in balance or surplus is necessary, if a new burst of world expansion is to take place. However, this can occur only if Japan and Germany end their dependence upon a massive export surplus for their prosperity.

There seems to be universal agreement among the purveyors of conventional wisdom and our complaisant political leadership that the United States Government's budget deficit was in some way responsible for the stock market decline and that this deficit has to be cut unless the market decline becomes a harbinger of an economic catastrophe. The government deficit was not the cause of the stock market collapse and, by itself, lowering the government deficit will only promote a recession.

An inept American budgetary structure which made unproductive government deficits a permanent feature of the American economy, may have contributed to the market's crash by undermining confidence in the competence of the leadership of the United States.

The United States's tax and spending structure needs to be changed so that at an appropriate income level—what used to be called full employment—the budget is balanced and at any downside from that level the government runs a strong deficit. (Inflation should act to generate a large surplus.) This policy of a balanced budget at a target performance level is in sharp contrast to the permanent deficit that the Reagan administration's ideology has produced.

The White House and Congress are engaged in a budget cutting exercise. A deadlock is developing over what package of tax increases and spending cuts is to be enacted. This exercise is only a symbolic offering to loudly voiced sentiments—nothing serious is likely to happen. In the give and take among the White House, the Republicans, and the Democrats in the Congress there is no recognition that the cavalier changes in the tax and spending programs that took place over the past seven years compromised the integrity of the United States fiscal system and that these changes need to be undone.

One step towards correcting the deficit impasse would be to increase taxes by reintroducing progressivity into the revenue system, i.e. taxation according to the ability to pay. Two levels of surtax should be introduced: The first would be a 10 percent surtax on all incomes between $100,000 and $500,000 and the second would be a surtax of 20 percent on all incomes in excess of $500,000. Given the late date and the likelihood of a recession in 1988, these surtaxes should begin January 1, 1989.

Simultaneously, we should make a downpayment on disarmament by shifting some $10 billion dollars from the military budget to a high employment content works program: a combination of a modernized Works Progress Administration and a new Civilian Conservation Corps. These would be reminiscent of the successful programs of the New Deal days. Such programs, which replace doles by jobs, are a necessary ingredient of any successful capitalism.

As the repercussions of Oct. 19 work their way through the economy, it must be kept in mind that it was a combination of government budget deficits and prompt and apt intervention by the Federal Reserve that first contained and then promptly reversed the recessions of 1967–68, 1974–75, and 1981–82. Trying to eliminate recession induced budget deficits can only make recessions worse, not better. It would be a good confidence builder if the negotiators on the budget would signal that the deficit would be allowed to increase as a recession takes hold, but that fundamental tax and spending reforms were being put into place so that when private demand drives economic expansion, budgets would be either in balance or in surplus.

Whoever takes over the White House in January 1989 will have to undo the harm that Reagan has done to the economy. The election campaign and the inauguration may very well take place while the country is in a recession. This will make the political task somewhat easier, for in a recession, when it is obvious to all that things could be better, the people will listen to programs of reform. In these efforts, nothing will be more important than to make the distinction between a budget that is in surplus, balance or deficit, depending upon whether the economy is above at or below some well defined target, and a budget that is in permanent deficit because of an unwillingness or inability to tax enough to fund expenditures.

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It will take several years to feel the full impact of Oct. 19th and the yo-yo behavior that followed.

Never underestimate the ability of politicians and economists to make a bad situation worse.

CANADA

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Then a series of internal events in the Western Hemisphere touched us all. Parallel with the Vietnam War came the so-called Counter Culture. It was a social movement based on international interchange. The hippies saw themselves as citizens of the world. Away with borders. Defy the law. Throw out all restrictions. They were all brothers and sisters. Live to the full. The very naivete of this phenomenon was moving. The social yeast was fermenting. Nationalism was dead and buried in the path of such demonstrative brotherhood.

As we know, the Counter Culture fell apart, was co-opted by merchandisers, ripped apart by internal strife, upended by the impossible dream of a utopian society of *liberte, egalite et fraternite.* Had that not been tried in France, back in 1789, in the Paris Commune of 1871, and again in May, 1968? Ah, yes, but *plus ca change, plus c'est la meme chose.*

The hippies began to clean up their act, switched from Acapulco Gold to nose candy, wore power suits, carried attache cases and acquired the corporate look. They became respectable. They began a cautious flirtation with nationalism.

Here and there, single voices rose. We are nationalists, they said. They said they were concerned about Canada's national identity, about its cultural sovereignty. Woe to the American corporate bullies who came and stole our ideas, exploited our resources, threatened our intellectual savvy, enriched themselves at our expense.

"Stop!", the new Canadian nationalists shouted. "We want to remain masters in our own house. Keep the longest undefended border open, sure, but keep up the invisible barbed wire nevertheless. Hostile Americans need not apply in Canada. Canada for Canadians! Independence forever! No fifty-first-state status for Canada. Over our dead bodies!"

Then this nationalistic hysteria died a number of small deaths in the seventies. But the hardcore, professional nationalists remained watchful. In the early eighties the economies of both the U.S. and Canada went into a gentle tailspin. The nationalists perked up and shouted, "We told you so!", when the Americans put up protectionist tariffs. Soon it became a childish game of tit-for-tat, with no end in sight.

Then the Prime Minister and the President started to explore the idea of free trade. "Woe is us!" shouted the nationalists. The hysteria was reborn overnight. "Down with free trade!" was the slogan of countless professional organizations and political parties. The tenor was distressingly similar. Free trade was a bad notion.

Will somebody please accept that for many Canadians, nationalism per se is pure, unmitigated anathema? That for us free trade is the only solution, no matter the agony and the ecstasy in its wake? That tearing down borders, dismantling tariffs, abandoning restrictions, accepting every last citizen of this world as an equal, discarding xenophobia, are the antidote to perdition? That international interchange is the only solution in a world suffering from the hate-filled slogans of jingoists and ultra nationalists?

In July I attended a writers' conference in Tacoma, Wash., where I met Molly Friedrich, a literary agent for the Aaron Priest Agency in New York. When she heard I was a Canadian, she told me that her father's attempts at researching the famous Canadian pianist Glenn Gould's life for a biography he was planning had met with hostility in Canada.

Ms. Friedrich accused us Canadians of being jingoists. Her remark stung, and my feeble response, "You are calling *us* jingoists?", was cheap and off the mark.

Why should an American author not be encouraged to write the biography of a famous Canadian?

Why should a Canadian author not be encouraged to write the biography of a famous American?

The hippies became respectable and began a cautious flirtation with nationalism.