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IS "IT" HAPPENING?

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Ever since the 1930's a specter has haunted the capitalist world: The specter is that "It" can happen again where "It" is a run of financial and economic crises (such as took place between 1929-33) which leads into another Great Depression. Today's headlines and lead articles give the details of a broad spectrum of financial trauma including the continuing saga of Latin America, the unwinding of some junk bond deals, collapsing Savings and Loan Associations and the grappling by the Administration and Congress with the bankruptcy of the FSLIC. Furthermore for every crisis that occurs a multitude of potential crises loom on the horizon. Events force us to ask not "Can "It" Happen Again?" but "Is "It" Happening Now?".

Irving Fisher, Yale's great economist of the first part of this century, argued that once an economy is over indebted an initiating event, such as the stock market crash of October 1929, can set off destabilizing interactions among financial, product and labor markets which lead to a Great Depression. He called the destabilizing interactions a "debt deflation". During a debt deflation market processes lead to a cascading collapse of prices, wages, profits, asset values, output, and employment. An explosion of bankruptcies of both financial institutions and ordinary businesses takes place during a debt deflation.

Once a debt deflation is under way the normal behavior of free markets makes things worse not better: "markets" need to be dominated by interventions and institutionalized constraints if such disasters are to be avoided. Federal Reserve and government interventions failed to contain the collapse after 1929. Interventions have contained the repercussions of recent financial disturbances, such as the "Collapse of Mexico" in 1982, the failure of Chicago's Continental Illinois Bank in 1984, the stock market crash of 1987 and the continuing crisis of the thrifts.

The evidence shows that apt interventions by the central bank and government to support asset prices, output prices and profit flows and contain bankruptcies can abort fledgling debt deflations and keep recessions short and not very deep.

Today's capitalism differs in significant ways from that of 1929. In 1929 the Federal government was small, it was about 3% of GNP. It is now between 20% and 25% of GNP. During 1929-33 the Federal Reserve was constrained by gold standard rules, today no such rules apply. Furthermore the lender of last resort responsibilities of the Federal Reserve are more clearly understood and deposit insurance, which the full faith and credit of the Federal Government underwrites, now supplements the Federal Reserve.

The great collapse was not an uninterrupted fall. Pauses in the decline and even modest recoveries took place during the 3 1/2 years between October 1929 and March 1933. A debt deflation now would not replicate what happened in 1929-33. We can expect that it would take much longer to reduce the economy to an incoherence like that of the winter of 1932-33. The evidence from experience since the 1960's, shows that big government capitalism with intervention prone Central banks, such as we now have, is more resistant to a debt deflation and a subsequent great depression than small government capitalism with Central Banks that abstain from intervening. However more resistant is not the same as immune.

DEBTS AND OVERINDEBTEDNESS

One current concern that leads to the question "Is "It" Happening" is the burden of debt. Debts are prior commitments of incomes: each day commitments made in the past come due. The normal functioning of the economy requires that almost all commitments be met. Business debts are prior commitments of gross profits (or cash flows), household debts are prior commitments of wages and salaries, government debts

are prior commitments of tax revenues and international debts are prior commitments of export earnings. All of these prior commitments have risen relative to their supporting cash flows.

Overindebtedness exists when the ratio of payment commitments ~~and~~ to the supporting income flows is so high that a not unusual shortfall of incomes or a quite normal increase the carrying costs of debt can lead to a substantial inability to fulfill contractual payment commitments. Overindebtedness may result from the joint imprudence of borrowers and lenders, an unexpected rise in interest rates, or a shortfall of the incomes that were expected to fund debt commitments. In particular a fall in gross profits increases the burden of business debt and unemployment increases the burden of household debts.

The merger, take over, and buy out developments of the past several years have substantially increased the pledging of gross business profits to the validation of debts. It is a common concern that if a recession takes place the repercussions of a shortfall of profits will tend to amplify the recession.

THE FUNDAMENTAL EQUATIONS OF A CAPITALIST ECONOMY.

Gross profits are central to the proper functioning of a capitalist economy. Expectations of profits from operating existing facilities motivate business to hire labor. Expectations of profits from new endeavors or new plants motivate business to invest. Adequate realized profits enable business to fulfill obligations on debts: they signal that business men were right when they invested and bankers were right when they financed investment. Profits are good for the morale of business men and bankers.

Jerome Levy in the 1910's and Michal Kalecki in the 1930's focused on what determined profits. They showed that in a skeletal capitalist economy

Profits = Investment.

They also showed that in a capitalist economy with a government and international trade

$$\text{Profits} = \text{Investment} + \text{The government deficit} - \text{The deficit on international trade.}$$

These equations state a fundamental relation of capitalist economies: aggregate profits are determined by the pattern of spending. Investment and the government's deficit are pluses for profits whereas a trade deficit is a negative for profits. A debt deflation followed by a deep depression can occur only if profits collapse. Stabilization policies, whether discretionary or built in, that lead to large deficits as a recession develops help abort debt deflations and contain depressions because they sustain profits.

THE LEGACY OF PRACTICAL MONETARISM.

In October 1979 Paul Volcker, newly appointed as Chairman of the Federal Reserve System, installed "practical monetarism" as the operating rule for monetary policy. Until July 1982, when the Mexican debt crisis and the failure of the Penn-Square bank in Oklahoma forced a change, Federal Reserve operations aimed to achieve target rates of growth of the money supply. The Federal Reserve let "the market" determine interest and exchange rates.

The current savings bank crisis, the bankruptcy of the FSLIC, and the need for a major infusion of Government funds to validate the deposit insurance commitment, as well as the Latin American debt crisis and the crisis in manufacturing, are delayed effects of practical monetarism. We will examine the S&L crisis in some detail because it well illustrates the role of government in containing disastrous consequences of market behavior.

The interest rate patterns that developed when the Federal Reserve followed monetarist precepts made the financing costs of S&Ls greater than their interest income. This negative fund income stripped the S&Ls of their equity. As equity vanished the

market price of S&L stocks dropped sharply. This meant that a small investment could buy control over a large body of money. When this happened the old populist saying "A bank charter is a license to steal." became relevant.

DEPOSIT INSURANCE

Deposit insurance was never and can never be insurance. At best the insurance reserves could validate deposits in isolated institution that fail because of fraud or gross incompetence. They can never be large enough to validate failures that are due to systemic economic problems. Once systemic problems arise deposit insurance is viable only because it carries a pledge of the full faith and credit of the Federal Government.

Insured deposits at the Savings Institutions, Federal guaranteed mortgages, and the fixed payment, fully amortized home mortgage, which were instituted by the New Deal, were in part motivated by the view that short term mortgages, that required periodic refinancing, were a significant cause of the great depression. The financing of long term mortgages by short term deposits was encouraged by public policy. There was an implicit commitment that policy would not allow short term rates to be so high for so long so that the integrity of this financing structure would be destroyed. The 1979-82 experiment with policy based upon monetarist precepts violated this commitment: policy assured that short term interest rates would be high and would stay high.

The experiment with practical monetarism changed the rules of the game which had made the S&Ls viable. The bill for the monetarist policies of 1979-82 have come due in 1989. The choice is between paying up or risking a thoroughgoing debt deflation.

WHAT THE FSLIC SHOULD HAVE KNOWN

Prior to 1979-82 depositors at S&L's were protected by positive cash flows because interest income exceeded interest expenses, owners equity and deposit insurance. In turn the insurance fund was protected by the S&L's positive cash flows and equity.

When a banker notes that a borrower is making losses or that the protection his loans enjoy is being eroded because asset values are falling he imposes additional constraints upon the borrower. As practical monetarism inverted cash flows and destroyed the equity of the S&L's the FSLIC's regulation should have become stricter. Instead regulation slackened. The Reagan era's propensity to deregulate infected both the national and the state regulators of the savings industry.

Those who gained control of virtually bankrupt S&L's with a very small investment often sold the regulators and local politicians on fanciful strategies which they contended would enable them to grow out of the losses and the negative net worths. The combination of continued strong demand for real estate financing and a weakened S&L ability to fund real estate financing led to the development of securitization. The fee income that resulted from an expansion in size and activity of the S&L's offset the negative fund income, so that S&L's were able to sustain an illusion of profitability.

The regulator's belief that deregulation was good meant that campaigns by S&L's for wider portfolio options and the right to issue broader classes of liabilities found favor. When S&L's gained the right to act as a principal in real estate development, negative net worth institutions were given the power to enter high risk activities with the insuring agency's guarantee providing the only protection of their depositors. The game that was played was heads I, the S&L's owners or management wins, and tails you, the FSLIC, lose.

Deregulation increased the options available for self serving owners and management which assured that the value if the liabilities exceeded the value of the assets. The combination of practical monetarism and slack regulation made it "scoundrel time" in the thrift industry.

WHAT TO DO.

The problem is to develop policies that will abort or contain an emerging debt deflation and create a financial environment conducive to sustained growth. The premise is that if there were no FSLIC, no FDIC, no enhanced Federal Reserve, no pledge of the full faith and credit of the United States government and a small 1929 scale government we would now be in a debt deflation analogous to, though not a replica of, that of 1929-1933.

A first step is to face up to the need to refinance the FSLIC. Congress and the administration should not equivocate, they should not try to evade picking up the tab for refinancing failed and failing S&Ls and the FSLIC. They need to recognize that the full faith and credit of the United States is all that stands in the way of a disastrous run on the deposits of savings institutions and commercial banks. The "pay off and liquidation" of insolvent savings banks and a modernized Reconstruction Finance Corporation which will refinance institutions that are worth saving should be fully funded. Overt government ownership or participation by way of the new RFC should replace the subsidized private ownership that characterizes the deals made in 1988.

One result of either a pay off and liquidation or an RFC rescue will be that a Federal government agency will hold a mass of non performing assets. These assets should not be thrown on the market to fetch what they can. The liquidation of the government holdings of forfeited assets needs to be a slow process.

Full Faith and Credit

The full faith and credit of the United States is only as good as the government's income allows. Governments, like businesses and households, have to validate their

debts with income. Taxes are the income of government. The refinancing of the S&L's and perhaps banks requires an increase in government debt and therefore in the government budget item, interest.

In the light of the large foreign holdings of United States assets, a tax system that yields enough to pay the costs of current government activities and to validate the debt needs to be either in place or on the horizon if a framework for resuming tranquil growth is to be put in place. Even without the debt taken on to refinance the financial structure the government is running a deficit. Clearly if the pledge of the full faith and credit is to be meaningful government revenue needs to be increased.

As we know from the Levy-Kalecki equations profits will fall if the government moves from deficit towards a balanced budget. This decreases the ability of business to validate debts and lowers the employment that businesses offer. An increase in unemployment decreases households' ability to validate debts.

The Trade Deficit

The foreign trade deficit is a minus for profits. A lower trade deficit can offset the impact that higher taxes will have on profits. The fiscal system of the United States should include a revenue raising tariff: say 10% on all imports. Such a tariff may well raise in excess of \$40 billion dollars and lower imports by some \$40 billion. The reduction in imports will increase domestic profits. The remainder of the budget deficit can be closed by a modest gasoline tax combined with an equity enhancing surcharge on the income tax.

The financing of the government deficit and the lower quality of government debt which result from the inadequate revenue system are causes of the current high interest rates. An adequate revenue system for the United States will raise the quality of

government debt and thus lower interest rates. This will not only lower government spending but will decrease the interest payments of businesses and households.

Any policy agenda that includes a tariff will raise cries of "protectionism". We now have selective protectionism based upon exporter administered quotas. This is a *greater* efficiency distorting intervention than a tariff that aims to raise revenue.

When countries with large holdings of foreign assets sustain their domestic prosperity by running chronic trade surpluses, as Japan and West Germany now do, they are "beggaring their neighbors". They are achieving prosperity by impoverishing their trading partners. A country being beggared is remiss if it does not take steps to turn its trade deficit around. An across the board tariff which aims to earn revenue is a modest measure to restrain the beggaring. The export addicted countries that hold large stocks of international assets need to be coerced into doing their part to sustain gross profits in debtor countries.

A tariff for revenue will increase the market power of domestic business and labor. Effective anti trust is needed to prevent exploitation of this power.

Apt and Inept Government

The debt deflation phase of the great depression ended in March 1933. We are now nearer to having a debt deflation than at any time in the half century since the great depression ended. But a debt deflation is not inevitable. We can use government in a positive way now, before our current crisis gains momentum, or we can allow a debt deflation to develop, pay the price of a disrupting depression, and then refinance our financial institutions.

Even if the worse happens and the Administration and the Congress do nothing constructive, the very size of government makes a decade of depression such as occurred in the 30's unlikely. We are paying for 1980's inept combination of practical

monetarism, myopic deregulation and fiscal irresponsibility. The lesson from the twentieth century is that apt government is a necessary ingredient for successful capitalism and inept government is a prescription for disaster: nothing that happened in the 1980's contradicts this lesson.

In 1989 the answer to the question "Is "It" Happening Now?" has to be perhaps. But we must also appreciate that overindebtedness in a big government interventionist capitalism may well lead to the whimper of an unsatisfactory performance rather than the bang of a deep and prolonged depression.