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Will "They" Let "It"---A Financial Crisis and a Deep
Depression--- Happen?

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In his columns of the week of July 13 and in articles and columns that have followed Leonard Silk, the principal commentator on economics of the New York Times, has raised the spectre of "It" happening again, where "It" is a financial crisis which leads into a depression that is potentially of the order of magnitude of that of the 1930's. Silk is not alone in his concerns about the stability of the American and world economies. Although the representative mainstream academic economist in the United States shows no such concern, many economists working for financial institutions are concerned about the potential adverse effects upon the economy of what they call the deterioration in the quality of credit.

Fears of a big crash became more open in the week of July 13 because the stock market decline of the previous week continued, the once great Bank of America reported losses of more than \$600 millions, a large bank in Oklahoma failed, the Hunt empire of Texas seemed to be crumbling (which could add to the troubles of the banking system), and the number two steel maker, LTV, sought the protection of the bankruptcy courts. This spate of bad

news plus the weak performance of GNP in the second quarter made Silk and other serious observers raise the "It" question. To them it seemed as if the center might not hold - the taut financial structure might break.

July begins the second half of the year. At this time economic forecasters turn their attention to what the next year will bring. It almost seems as if the elaborate models economic forecasters profess to use are irrelevant. The forecaster begins with a view of the normal behavior of the economy. He then forecasts that the economy will behave in the usual way or will compensate for past deviations from the normal. Thus a usual forecast is that the next six months will be quite like the past six months, with some adjustments towards some normal values, and next year will be normal or will compensate for this years deviation from the normal.

Even as Silk and other economic commentators and forecasters were considering the possibility that there will be a true or a growth recession soon, the administration, through the Office of Management and Budget (OMB), was forecasting a burst of rapid expansion in 1987. The OMB has implicitly adopted a compensatory view of how the system works, next year will make up for the shortfall this year.

Of course the government forecast may be motivated by the political need to posit a large increase in G.N.P. so as to keep the deficit that the projected spending and taxing programs will generate within the Gramm-Ruddman guidelines. Given the constraints upon allowable budget deficits that the Gramm-Ruddman approach to fiscal policy imposes, the forecast of the OMB, which is used in preparing future budgets, is now of much greater

significance than hitherto. Because spending and tax receipts are sensitive to G.N.P. the forecast determines the allowable planned spending.

On a deeper level the differences between what Silk is urging us to take into account and the optimistic OMB forecasts rest upon the economic theory they are implicitly using. It is difficult to believe, but it is nevertheless true, that the financial considerations that are central to Silk's observations are ignored in the theories and models that underlies the way most government and private forecasters look at the economy.

It is the financial tautness, as exemplified by the events of the week of July 13, that makes the government's forecast of good times so unbelievable. The taut financial situation that now rules may not lead to a financial crisis and deep depression in the near future. But vigorous expansion of the kind projected by the OMB requires a rapid increase of business indebtedness. The current levels of business debt means that either no such burst will take place, or if it does occur it will be short lived. Therefore the best that can be expected is a continuation of sluggish expansion, the worst is a cycle of debt repudiation, widespread failures of businesses and financial organizations, and a rapid fall in income.

To decide whether the concern that "It" can happen again is relevant it is necessary to determine whether the defenses against big depressions that were built in the aftermath of the Great Depression are likely to hold against the financial tensions that now exist or are likely to develop in the near future. To evaluate the adequacy of the defenses we need to understand what there is about our economy that makes a big depression the result of the normal

functioning of the economy as well as why we haven't had anything close to a repeat of 1929-1933 in the forty years since World War II.

For better or worse I have been identified with the "It" question for well nigh onto thirty years. In 1957 I published an article on the changes taking place in the United States money market and among the giant banks. I pointed out that the Federal Reserve had little power to constrain the economy, especially during times when financial innovations were taking place at a rapid pace, because financial markets and banking practices evolved in response to profit opportunities so as to offset the effects of the Federal Reserve's interventions. I pointed out that the cumulative effect of such innovations in finance was to increase the ratios of both payment commitments on debts to the underlying income streams and of debts to default free assets. As a result of this evolution over a run of good times the margins of safety in the financial structure decrease and therefore the financial structure becomes ever more fragile, more prone to market reactions being disequilibrating. As a result the likelihood of a financial crisis that leads into a serious depression increases.

I also pointed out that the reforms of the 1930's gave the authorities improved lender of last resort weapons to contain and reverse disequilibrating reactions in financial markets, so that a fully developed financial crisis need not occur even as the underlying conditions become favorable for such a disaster. In later papers and books I argued that the immensely larger size of the government made a collapse of income, employment, prices and profits, such as occurred between 1929 and 1933, less likely than when government was much smaller. Thus "It" will not happen as long as the Central Bank is an

effective lender of last resort and the government budget sustains business profits when private investment falls.

Overall the economy is usually well behaved, and an adequate description may interpret it as an equilibrium seeking system. (The "equilibrium" usually is a growth path not a stationary set of values.) However from time to time the description of the economy as an equilibrium seeking system becomes inadequate. This happens when the result of individual decisions, motivated by perceived self interest, tends to amplify rather than to dampen deviations. When such deviation amplifying behavior becomes prevalent economic tranquility is replaced by turbulence.

Implicit in the concerns raised by Silk is the view that the financial evolution of the economy over the years since World War II has changed the system from an initial financial robustness to a current financial fragility; the economy has changed from being equilibrium seeking to being potentially incoherent. This transition from robustness to fragility resulted from behavior motivated by the self interest of individuals, businesses, and banks in the context of our financially complex economy.

It follows that a financially complex capitalism, such as the very speculative American variety, can become disaster prone in that the system's reactions to an initial deviation does not dampen but rather it amplifies the deviation. Normal market reactions can tend to make a bad situation worse. However such disasters take place in calendar time; it takes time for them to be fully realized. In particular the disasters that are Great Depressions take enough time to mature so that they can be aborted by appropriate central bank

and fiscal interventions. But even successful abortions have consequences and often some of them are not immediately apparent.

The Federal Reserve and the Federal Government successfully intervened in 1966-7, 1969-70, 1974-5, 1979 and 1982 to abort incipient financial crises and contain recessions. In these episodes the intervention consisted of the Federal Reserve refinancing threatened organizations and markets while shifting to monetary ease, and the Federal Government running massive deficits which sustained business profits. The cumulative effects of these successes in containing potential disasters led to step wise increasing inflation that culminated in the double digit inflation of 1979-1980. Hapless Carter was as much a victim of the way crises and recessions were contained or floated off by inflation after 1966 as he was of the Iranian hostage crisis.

For the technique that was used in the past twenty years to be successful Federal Reserve and United States government liabilities must be viewed as safe and desirable assets by both domestic and foreign managers of portfolios. Federal Reserve and United States government debts will be such superior assets only if the dollar is scarce in offshore portfolios relative to payment commitments denominated in dollars and if the government is willing and able to tax to cover its normal spending programs. These preconditions -a strong international financial position and an orthodox Keynesian fiscal policy- were satisfied for the United States until the massive government and international trade deficits of the Reagan administration changed the picture. The twin Reagan deficits of 1981-86, which show no signs of abating in the near future, compromised the international financial strength of the United States.

Without the financial strength that ruled as recently as earlier in the 1980's it becomes problematical whether the techniques that worked in the past to stave off financial crises and big depressions will work as quickly and as efficiently the next time they are called upon. As recently as 1981-82 the United States, was able to contain downside movements of the world economy by containing downside movements of the American economy by running a profit sustaining deficit, and as late as the Continental Illinois debacle of 1984 the Federal Reserve was able to act as an international lender of last resort. It is an open question at this time whether the United States can sustain international stability if a crisis develops in the near future without significant aid and cooperation by other countries.

The financial system defences against another great depression, such as deposit insurance and greater portfolio flexibility for the Federal Reserve, that were put in place after the Great Depression, have led to the successful containment of financial crises. Big government and the deficits that are well nigh automatic during a recession have been successful in sustaining profits and therefore income and employment when a recession takes place. To date these interventions have been successful in containing both financial disruptions and recessions. The main policy question we now face is whether these defences will hold in the future.

↓ The United States is now a major debtor nation on its international accounts. In a recession its already large government deficit is likely to become enormous. Such a deficit might well lead to a flight from the dollar, so that a rapidly depreciating dollar results. The international financial markets will be indicating that the United States should practice constraint even as the domestic

employment and output situation calls for expansion. (The United States will be in a predicament similar to that of Mexico since 1982.) In this situation expansionary fiscal and monetary policies by the countries with appreciating currencies, most likely Japan and West Germany, would be called for. However recent experience in policy coordination makes it likely that the responses will not be prompt and are likely to be inadequate. The prospect is for too little and too late.

The world economy is not very robust when the traditional and experienced center cannot lead. In some ways the rapid decline of the financial strength of the United States makes the 1980's like the 1920's, when Great Britain, the leader of the world's financial structure for a century prior to World War I was no longer a robust enough economy to shoulder the responsibilities for world financial stability.

Whenever the prospect of another serious depression is raised a common response is that "They wont let "It" happen.". When I hear this my response is usually "Who are the "they" and what are "they" to do?". In the years since 1946 the "they" were the United States government and the Federal Reserve System. With the financial strength of the United States greatly reduced the United States Government, operating through its deficits, and the Federal Reserve System, operating through its control over monetary reserves and its ability to act as a lender of last resort, may not be able to do the job of containing a financial crisis and maintaining income the next time the need arises.

Because an intervention technique worked in the past is no guarantee that it will work the next time it is tried. The current financial weakness of the United

States means that the world economy is now in an exotic environment, where old prescriptions are not likely to suffice.

In the present situation it is not clear who the "they" are that are supposed to prevent "It" from happening and what "they" are supposed to do.

For the next financial crisis and recession to be contained the degree of cooperation among the major economic powers will have to be greater than they have exhibited in the past. We must be aware that for every potential adviser to the political leadership of the countries that will have to cooperate who is aware of the fragility of the world economy's financial structure and the need for apt intervention to abort crises and contain recessions there are many prestigious potential advisers whose economic theory leads them advise the political leadership not to intervene because markets are self equilibrating. Such advice if followed will open the gates to another debacle like that of the thirties.