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The Current State of the American Economy

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The recent behavior of the ~~American~~ economy - the rapid oscillation from accelerating inflation to serious recession - reflects the fragile nature of the financial structure and the way cyclical forces are resolved within the current structure of the economy. Over the past decade economic policy has been especially inept, for, even though experience and evidence indicate that the financial system was becoming even more fragile, neo-classical economic theory, on which policy is based, has no room for concepts such as financial robustness and fragility. If we are to do better, policy must be based upon theory that recognized the upward and downward destabilizing influence of finance. Policy needs to be directed towards generating financial structures which are less prone to financial instability than our current system.

At this date, when the resolution of the problems of the R.E.I.T.'s and the giant banks that finance them is very much at issue, it is evident that unstable financ~~ial~~e ~~situations are~~ is a fact~~s~~ of life. The present tenuous financial situation is the third near crisis in a decade; the credit crunch of 1966 and the Penn-Central/Commercial paper crisis of 1970 being the first two.

These two earlier near crises were resolved by actions of the Federal Reserve and the fiscal authorities which had the effect of floating off the threat of a debt-deflation by an accelerating inflation. The monetary and fiscal responses to the current instability and recession are setting the stage for a quick resumption of accelerating inflation. The "intrinsic value" to which R.E.I.T.'s and Commercial bankers appeal when non-earning assets are kept on their books at face value reflects a belief that in the near future demand will be sufficiently strong and factor costs sufficiently high so that the investments underlying their financial assets will be "healthy"; i.e. further inflation is necessary to validate these investments.

As a result of war finance, and the reforms and memory of the Great Depression, we entered the post-war period with both a robust financial system and a tendency towards defensive finance. Because banks, businesses, and households had large reservoirs of liquidity in the form of Treasury securities and excess cash, units that needed cash dealt in assets. These reservoirs of liquidity also meant that interest rates were low and stable. Units were able to absorb transient financial difficulties without significantly changing their operations. The financial system was robust.

The business cycles that occurred during the first two decades after the war were caused by either monetary constraint, fiscal drag, or the effects of ceilings to activity. These moderate cycles were devoid of financial dislocations and there was no fear that they would degenerate into deep depressions.

Over the post-war years, changes have taken place which makes the financial system less robust and more fragile. In the 1950's banks used up their "stock" of excess reserves and Treasury securities, the Federal Funds market re-emerged. In the 1960's negotiable certificate of deposits were introduced. These were significant steps in the growth of liability management banking, i.e. the acquisition of cash by operating in debts. Since the early 1960's the commercial paper market, the Euro-dollar market and both eligible and ineligible acceptances became more important. In addition, the emergence of fringe banking (in the changed business of finance companies and the explosive growth of R.E.I.T.'s) and the close financial management by business were additional steps in the evolution of the financial system from robustness to fragility. Furthermore, throughout the postwar period non-member banks grew relative to member banks and in recent years there was a rapid growth in the assets/equity ratio of banks. Regulatory authorities throughout this period behaved as if serious financial difficulties cannot again occur.

A wave of corporate mergers and conglamorations took place; these increase the indebtedness of corporations without changing the stock of capital assets, thus increasing the commitments to make payments on debt relative to corporate cash flows. The general pervasive shortening of corporate debt increases the need to pay debt by new debt. Such speculative finance is a basic source of financial instability.

As a result of such changes the business cycles is now quite different from the business cycle of the 50's. The protracted expansion of the Kennedy-Johnson years, rather than demonstrating a new stability to the economy, marked the maturing of unstable financial interrelations.

The first of the new breed of cycles occurred in 1966, the second in 1970, and the third is now at "crisis" stage. The stages and contours of these recent cycles are different from that of the earlier post-war business cycles. The elasticity of finance due to these institutional changes permits the emergence of an inflationary explosive boom. The financing of the boom decreases liquidity, so that monetary and fiscal constraint now triggers, with a lag, financial dislocations leading to a near crisis. Federal Reserve intervention, as a lender of last resort, aborts the crisis by feeding reserves into the banking system. Because of the scare, a decline in income takes place (in 1966 this was a growth recession), but monetary and fiscal measures sustains and revives the economy - although a sluggish trough might result. Once recovery takes place, the economy is soon off to another burst of inflation, which once again leads to monetary constraint and an incipient crisis in finance.

Thus the post 1966 business cycle includes stages - accelerating inflation, serious financial dislocations, and threats of a debt-deflation - that were absent in the earlier post-war business cycles. Our present choice seems to be between accelerating inflation and a serious debt-deflations with a resulting deep depression.

The current financial structure, combined with the flaws in the policy advice that stems from neo-classical theory, have placed an unreasonable burden on the Federal Reserve System. Critical as I am of the Federal Reserve, in the past decade they have been more sinned against than sinning. On the one hand it is argued that the Federal Reserve can fine tune the economy and this leads the Federal Reserve to try to manage the money supply to induce non-inflationary growth. On the other hand threats of financial instability force the Federal Reserve to do what it was originally designed to do - act as a lender of last resort, i.e. abort incipient financial crises. The Federal Reserve in acting as a lender of last resort floods the economy with liquidity, not only in the conventional sense of bank reserves but also by validating the financial practices that financed accelerating inflation.

In doing so, the Federal Reserve, in combination with sustaining fiscal policy, sets the stage for a new burst of accelerating inflation.

Nowhere in either the Standard Keynesian or the Monetarist branches of neo-classical theory is there any conception of how financial instability is generated. In fact, they agree that money, the most endogenous of phenomena within capitalist finance, can somehow be encapsulated in a measured exogenous variable.

To do better we need to base policy upon a theory that recognizes that capitalist finance is destabilizing in rather massive ways. To get out of the sorry state we are in we need two things. First we need a depression without a depression, during which corporate investment and household purchases are constrained to what can be readily financed by internal cash flows while income is maintained by government direct employment policies. In addition we need institutional reforms which go deep into corporate and household finance and banking (broadly conceived) so as to constrain the destabilizing tendency towards speculative finance which is basically responsible for the booms and accelerating inflations that set the stage for financial instability.