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IS "IT" HAPPENING?

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This is a spin off from comments made on March 18, 1989 at the Jerome Levy Economics Institute of Bard College.

Hyman P. Minsky is the author of Can "It" Happen Again?, (M.E. Sharpe & Co., 1982) where "It" is another Great Depression. Up to now his answer has always been "not yet".

Ever since the 1930's a specter ^{the specter is} that "It" can happen again has haunted the capitalist world ^{where} "It" ^{is} being a run of financial and economic crises (such as took place between 1929-33) which ^{leads into} ~~becomes the first phase~~ of another Great Depression. Today headlines ^{about} a broad spectrum of financial trauma, including the wholesale collapse of Savings and Loan Associations and the bankruptcy of the FSLIC, force us to ask not "Can "It" Happen Again?" but "Is "It" Happening? ^{Now?"}

In 1933 Irving Fisher, Yale's great economist of the first part of this century, argued that once an economy is heavily 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, *in which each unit seeks to maximize its "wealth"* 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, is part of a debt deflation.

Once a debt deflation is under way the normal behavior of free markets makes things worse not better. *The burden of debt, which was high in 1929, increased between 1929 and 1933 even as some of the banks failed* Federal Reserve and government interventions failed to contain the *and households tried to reduce their liabilities* collapse after 1929. *In the recent financial disturbance the Federal Reserve has intervened to refinance its holdings at risk units and has also engaged in broad support* Interventions have contained the repercussions of recent financial disturbances such as the failure of Chicago's Continental Illinois Bank in 1984 and the stock market crash of 1987. *In the recent financial disturbance the Federal Reserve has intervened to refinance its holdings at risk units and has also engaged in broad support* The indications are that apt interventions by the central bank and government to support asset prices, output prices, profit flows and contain bankruptcies can abort a full fledged collapse. *supporting increases in the funding of the bank.*

Today's capitalisms differ in significant ways from those 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, Congress and the President assure us, is supported by

the full faith and credit of the Federal Government, supplements the Federal Reserve. Changes which parallel those in the United States have taken place in the other main capitalist economies.

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: 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 financial trauma again emerged in the late 1960's indicates that big government interventionist capitalism, such as we now have, is more resistant to a debt deflation and a subsequent great depression than small government non interventionist capitalism, such as that of the 1920's.

As we examine our present situation and look to the future we must keep in mind that more resistant is not the same as immune.

DEBTS AND OVERINDEBTEDNESS

One current concern is the burden of debt. Debts are prior commitments of incomes: each day commitments made in the past come due and normal functioning of the economy requires that almost all commitments be met. Business debts are prior commitments of profits, household debts are prior

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commitments of wages and salaries, government debts are prior commitments of tax revenues and international debts are prior commitments of export earnings.

Overindebtedness is a relation between payment commitments and income flows. Overindebtedness may result from the joint imprudence of borrowers and lenders, when interest ~~payments~~ ^{in the} unexpectedly rise, or when incomes that were expected to fund debt commitments are not forthcoming. In particular a fall in gross profits increases the burden of business debt and unemployment increases the burden of household debts.

THE FUNDAMENTAL EQUATIONS OF A CAPITALIST ECONOMY.

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 simple capitalist economy

$$\text{Profits} = \text{Investment.}$$

They also showed that in an economy as complex as ours

$$\text{Profits} = \text{Investment} + \text{The government deficit} - \text{The deficit on international trade} + \text{Consumption financed by profit income} - \text{Saving out of wage income.}$$

These equations state a fundamental relation of capitalist economies: aggregate profits are determined by the pattern of spending. Investment, the governments deficit, and consumption financed by profit income are pluses for profits whereas the trade deficit and saving out of wage income are negatives for profits. A debt deflation followed by a deep depression can occur only if profits collapse. Stabilization policies that lead to large deficits as a recession develops succeed in turning the economy around 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 focused on achieving 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 are delayed effects of practical monetarism. The interest rate patterns that developed when the Federal Reserve followed monetarist precepts made the S&L's financing costs greater than their interest income. This negative fund income stripped the S&L's 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

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motivated by a commitment to home ownership and 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} An implicit commitment that short term rates would not be permitted ^{to rise so} to rise ^{that} too high for ^{prompt major losses occurred.} ~~too long underlaid policy.~~ ^{the} In 1979-82 monetary policy of 1979-82 assured that short term interest rates would be high, ^{by} constraining the ability of banks to acquire assets. This guaranteed that the S&L's ~~were~~ would make losses.

In 1979-82 the rules of the game were changed. What is at issue in the current S&L crisis is not a bailout, but how ^{now} ~~we~~ to pay for a string of inept policies.

WHAT THE FSLIC SHOULD HAVE KNOWN

Prior to 1979-82 depositors were protected by the S&L's positive cash flows, 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 and that the protection his loans enjoy is being eroded he imposes additional constraints upon the borrower. As practical monetarism inverted cash flows and destroyed equity the FSLIC's regulation of the S&L's should have become stricter. Instead regulation slackened. The Reagan ^{As you recall however & the S&L "problem" was a common one} today's Wall Street Journal (April 27) One realizes how little sense the S&L. regulation really had.

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 weakened S&L's led to the development of securitization. The fee income that resulted offset negative fund income so that S&L's were able to sustain an illusion of prosperity. *Fee income in net cash income*

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. The right to act as principal in real estate development meant that negative net worth institutions were given the power to take risks not with their own funds, for these were nil, but with the funds of their depositors and the insuring agency. The game that was being played was heads I, the S&L's win, and tails you, the FSLIC, loses.

Deregulation increased the options for self serving by management. The policy 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.

Policy should not equivocate. Congress and the administration 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 disasterous 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 none or partial 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. 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 enhanced.

A tax structure that is sufficient to pay for the government's purchases, its commitments in the form of entitlements, and the interest obligation on the debt is needed. As we know from the Levy-Kalecki equations profits will fall if the government moves from deficit to 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 of higher taxes 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 a 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 burden of business and household debts.

Protectionism and Beggar Thy Neighbor

Any policy agenda that includes a tariff will raise cries of "protectionism". We now have selective protectionism based upon exporter administered quotas. This

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is a much efficiency distorting than a tariff that aims to raise substantial 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.

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 intervening half century. 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 period of disruption and 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 another decade of depression unlikely. We are paying for 1980's inept policy combination of practical monetarism, myopic deregulation and fiscal irresponsibility. The lesson from the past half century is that apt government is a necessary ingredient for successful capitalism and inept government is a prescription for disaster.