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1-15-1991

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Hyman P. Minsky Ph.D.

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Recommended Citation
Minsky, Hyman P. Ph.D., "1991: Recession or Depression?" (1991). *Hyman P. Minsky Archive*. Paper 206.
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Jan 15, 1991

1991: Recession or Depression

Hyman P. Minsky.
The Jerome Levy Economics Institute
Bard College
Annandale on Hudson, NY 12504.

In the last week of 1990 a consensus developed in the United States that a recession had started. Before the second week in 1991 ended, even as the United States was preparing for war, concerns were expressed that the United States was not in a recession but in the early stages of a depression.

The evidence ~~that was cited~~ to support the proposition that this might be a depression includes:

1. The bankruptcy during the first week of 1991 of the 22 billion dollar Bank of New England, along with indications that other big banks as well as the fund that insures bank deposits are in trouble.
2. The continued decimation of the institutions that specialize in home financing (the S&L's) and the spread of like problems to the insurance industry.
3. The apparent acceleration of the collapse of some regional real estate markets.
4. The sinking spell of already low equity prices on Wall Street.

Depressions are not merely deep and long recessions, they are much more complex. They result from processes in which contractions of total demand, failures in the financial structure and a shift away from risk taking in portfolio preferences interact to create a downward spiral of the economy. In a recession gross national product decreases, unemployment increases and the rate of inflation abates. In a depression, in addition to all of the above, financial institutions collapse, asset values and thus private wealth fall, and investment and profits head towards zero.

A decline in total demand leads to a fall in the cash flows (profits, wages and tax receipts) which businesses, households and state and local governments use to meet their financial obligations. A rise in the non-performing assets of banks and other financial institutions follows. In a recession the financial institutions are robust enough so that they can take such losses without significantly decreasing the funds they make available to finance demand.

In a depression falling incomes weaken financial institutions so that the available financing decreases. Profits fall and so do asset prices which reflect expected profits . As a result the aversion of owners and managers of portfolios to risk taking increases so that the price in money of financial and real assets falls. Long ago Irving Fisher, a great American Economist, called this recursive process a debt deflation.

In the earlier recessions of the post war era the loop of the debt deflation process from lower incomes to the failure of banks and other financial institutions was not set in motion and no significant rush to low risk assets took place. In the 1980's a massive adventuring into exotic financing instruments and relations took place throughout the capitalist world. A sharp increase in corporate indebtedness, an explosion of household debts, and an infusion of high risk assets into the portfolios of banks and other financial institutions took place. The financial structure became increasingly fragile. The likelihood that a debt deflation and a deep and long depression will take place is much greater now than at any time in the past half century.

As 1991 begins conditions conducive to a debt deflation are present in Japan, Britain and other affluent capitalist economies as well as in the United States. International trade, international portfolio diversification and the impact of modern communicating and computing techniques have radically increased the integration of the world's economies. The need for international coordination of policies to contain a debt deflation is much greater now than in the past.

Will a deep and long depression take place? The consensus among professional forecasters is that this recession will be like other post war recessions, so that an economic expansion will begin in the second half of 1991.

But these forecasters use models are very weak on the financial dimensions of modern economies. If financial weaknesses are taken into account it becomes evident that the danger of a serious depression is greater now than at any time of the past half century.

Even so a deep depression is not inevitable. The policy responses in the leading countries will determine what happens. If important countries continue to fight inflation even as a major deflation of asset values and serious declines in income and employment are taking place, while others maintain a faith that market economies are self adjusting systems, even as the world economy deteriorates, then the policy responses are likely to be too little, too late and ill chosen.

In July of 1989 the leaders of the capitalist world met in Paris to commemorate the 200th year of the French Revolution. This fete was transformed into a celebration of the victory of modern Capitalism over the Soviet model of Socialism. In the 18 months that followed, the rout of the European Soviet Socialisms was complete.

It is ironic that even as the Soviet Socialist model is discredited capitalist economies are being put to their greatest test since the 1930's, when capitalism was clearly a failed system. Perhaps the celebration in Paris was premature. Capitalism is only a conditionally successful economic order. During a debt deflation the way free markets work tends to worsen, not to alleviate, the

shortfall of income and employment and the fragility of financial markets. Policy interventions which contain the debt deflation are necessary if the economy is not to "spin out of control". The "Government is inherently bad' philosophy that guided policy during much of the 1980's is wrong for the modern world.