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The Economic Consequences of the Hostage Crisis:
A Grim Assessment

Hyman P. Minsky

Events, especially traumatic events like the plight of TWA 847, have economic consequences. This is so because economic decisions, especially those which depend upon current views of the future, are affected by communal optimism or pessimism, by the self-esteem or self-doubt that rules. The ghost of Carter and the malaise he spoke of and represented now haunts the White House and is likely to rub off on business.

TWA 847 shows the impotence of American power in the world as it is. Reagan sold an optimistic assessment of our society, economy and place in the world in the campaign of 1984. He projected an image of action and competence. In the hostage crisis Ronald Reagan, the victor of Grenada, is as hapless as Jimmy Carter, the victim of Iran.

For several months the economy has been throwing out mixed signals. The inflation rate is declining, which is good, but unemployment is stuck at more than 7%, which is bad. The flash G.N.P. estimate indicates that expansion resumed in the second quarter after a stagnant first quarter but investment is down, agriculture is depressed, capacity utilization is at recession levels, and banks continue to fail. The evidence is accumulating that 1985 will fall short of the administration's forecasts.

The decline of investment in the flash estimate of G.N.P. is perhaps the most significant indicator of what we can expect. Investment is the fundamental and fragile facet of the economy: it depends upon the willingness of business men and bankers to take chances. Business, as Keynes remarked, is a mixed game of skill and chance, and investing requires that both business

men and bankers believe in their skill and luck.

TWA 847 is forcing a sober view of our international capabilities on us. A malaise such as Carter identified can start with the international humiliation and spread to how business and banks view the future. Our economy was not as bad off in 1980 as the popular assesment had it. Candidate Reagan benefited from and exploited the dispiritedness due to Iran.

Ample evidence for a pessimistic view of economic prospects existed before the hostage crisis. The full consequences of the world oil glut is just beginning to be felt in the price of oil. The very Arab radicalism that brings about highjackings feeds on the depression in the Middle East due to the loss of power by OPEC. A further decline of oil prices will have serious consequences in the United States for oil related industries, regions and banks.

The greatest downside potential in the United States in 1985-86 may very well be in commercial property. Vacancy rates are already high in the major oil cities and a decline in oil related prices - with its consequences for the prosperity of oil industries - will increase these vacancy rates. This could have serious impacts upon property prices, construction activity, and the lending financial institutions. Developments in commercial property that parallel what is happening in agricultural land prices would be disastrous for propserity.

It takes high animal spirits of business men and their bankers to overcome uncertainties and sustain sufficient investment so that prosperity rules. Even before TWA 847 animal spirits were not high enough to overcome the barriers due to business indebtedness, excessive capacity, and foreign competition. The sobriety if not pessimism that TWA 847 is likely to induce will make things worse, not better.

The prospect therefore is that investment will be weaker in the second half of the year than it would have been if 847 had not taken place. The stagnation of the first quarter is now more likely to return. The weakness of many financial institutions as well as the greater indebtedness of U.S. corporations, much of it due to the buy outs, takeovers and other financial games that Wall Street plays, mean that financial turbulence like that of 1974-5 and 1981-2 is likely to be induced.

Another period of recession and financial turbulence, like that of 1974-5 and 1981-2, will come - if not in 1985-6 then in another year or two. When we have another such crisis we will face it with the weakest economic team in government of recent years. Economists of substance and independent stature, like Weidenbaum and Feldstein, have been banished from Washington. Volcker, who has become a "master" at handling financial crises, can be expected to leave the Federal Reserve by the end of 1985.

The economists who survived from Reagan's first term and those who joined up since January are more known for their ideological "purity" than for their prowess as economists. This vacuum at the top is fitting, for Ronald Reagan has been his administration's chief economist. Economic policy in the turbulent years to come will reflect tired cliches and less than half truths rather than serious knowledge.

The vacuum in the administration is not the only vacuum in Washington. The Democrats may feel there is something wrong with Reaganomics, but they know not what. The issue they have adopted "fairness" doesn't lead to policies to manage and contain instability and to once again achieve something close to full employment.

Given the massive military build up the recession, due in the next year or so, should have been mild. The dispiriting effects of TWA 847 make a

recession more likely and increase the likelihood that it will be deep and long and accompanied by financial turbulence. The bankruptcy of knowledge and understanding in Congress and the Administration makes it likely that government intervention will be both late and perverse.

This grim assessment does not mean that the sky will fall in 1985 or 1986: 1929-33 is not in the offing. The government remains 20% to 23% of G.N.P., the defense build up gives us a dynamic leading sector, and the revenue system still responds in a stabilizing way to declines in income. Thus the forthcoming recession will be contained. If Reaganomics had its way in cutting civilian spending and changing taxes and if the defense program were not in place, the answer with regard to a repeat of 1929-33 would be different.