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7-1-1975

July 1975 Trendline

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Recommended Citation
Minsky, Hyman P. Ph.D., "July 1975 Trendline" (1975). *Hyman P. Minsky Archive.* Paper 198.
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July 75?

Trendline - Draft

Professor Hyman P. Minsky

A concensus had developed among analysts that the economy has "bottomed out" and the evidence confirms that the sharp decline that ruled between September of 1974 and March of 1975 has been halted. As the threats of serious financial dislocations have abated, as the prospects are that the recovery will be relatively sluggish, and as the deadlock between C ongress and the Administration precludes any meaningful policy initiatives in the near future, the likelihood is that we are in for a period of relative tranquility on the economic front. This makes this mid-year trendline 75 an appropriate vehicle for a longer run view of the economy; to inquire into the causes of deepest recession of the post-war era, the effectiveness of economic policy actions, and what the likely course of the economy will be over the next several years.

As recently as a month ago the fragility of the financial structure, which will continue to act as a damper on the economy for some time, seemed such that further financial disruptions, leading to a resumption of the precipitous decline, that ruled from Sept. '74 to March '75, seemed quite likely. The resolution, though incomplete and perhaps transitory, (1) of New York City's most pressing financial difficulties has removed one immediate threat of financial dislocation. The troubled (2) R.E.I.T. situation is now moving towards an orderly liquidation, thus removing another threat of financial market disruptions. In a relatively tranquil financial situation, such as now rules, the failure of one or more (3) of the large corporations whose troubles have been well advertised can be absorbed without causing any substantial difficulties. Thus an ~~era of orderly~~ behavior in financial markets seems to be in prospect. Not only should there

not be any repetition of large scale problems in financial markets, (+) but interest rate movements should be slow and orderly for the rest of 1975 and into 1976 unless strong policy actions, which seem unlikely, upsets the expected tranquility.

It is worth noting, in passing, how the troubled R.E.I.T. situation is being handled. The large multi-billion dollar banks - the banks which are mainly involved in this touchy situation - are refinancing the R.E.I.T.'s at running interest rates, which are substantially below the current market rates, with a contingent debt, by the R.E.I.T.'s, which represents the difference between a substantial mark up on the prime rate and the low running interest rate. (A typical example is a 2% running interest rate and a contingent interest rate 20% above prime. If prime is at 7% this implies an increase of 6.4% in the debt of the R.E.I.T. to the banks each year). For the R.E.I.T.'s to fulfill their contingent liability it is necessary for the assets of the R.E.I.T.'s to appreciate at at least 6.4% per year, in the above example. If this occurs the lending banks will come out healthy. If this does not occur - which seems quite likely - the lending banks will take their losses, on the original debts and the accrued interest, as the assets of the R.E.I.T.'s are liquidated. Thus instead of a one time substantial loss, the involved giant banks will be able to phase their losses, out of profits and loan loss reserves, over a number of years. There will be a downward pressure on earnings of the banks heavily involved in the R.E.I.T. fiasco, over the next several years.

Out there are glut of [illegible] > [illegible] construction industry get back to normal

Even though the threat of a financial crisis seems to be abated, a quick resumption of innovative, expansionary finance by the giant banks, such as ruled

since 1960 seems unlikely. Banking, and finance in general, underwent many quite radical changes in the years since 1960. These innovations in finance furnished the financial resources for the housing, investment, consumer durable (including automobiles), and inventory booms of the 1960's and early 1970's. These financial innovations led to a vast expansion of financial commitments relative to incomes by households and corporations. As a result of the disruptive effects upon cash flows and property values of the high interest rates and inflation many units got through the 1974/75 financial trauma by the skin of their proverbial teeth. Fear, based upon the narrowness of the escape, together with the concern of the regulatory authorities about the capital adequacy of banks, means that one necessary ingredient for a strong expansion - the availability of bank finance for 'speculative' purposes at reasonable terms - will be lacking in the next several quarters. Rather than being a period of financial experimentation and innovation, the remainder of 1975 and the first part of 1976 should be characterized by an unwinding of some of the more complex and unstable financial institutions and relations.

Thus the indications are that finances will neither push the economy into an even deeper recession nor propel the economy into a rapid and accelerating expansion in the next year or so.

The financial position of various sectors thus indicates that the outlook is for several years of high unemployment, sluggish investment, and a general, but slow, improvement in the economy. This financial effect is reinforced by the depth of the recession in housing and automobile production and the extent of excess capacity in industry. Even though automobiles production and housing starts have shown some improvement lately, the figures show that

housing starts in May were 48% of the cyclical peak of May '73 and automobile production May was .64% of the cyclical peak of July '73. Thus a substantial recovery will still leave these outputs well below prior levels.

The extent of excess capacity in industry can be visualized by comparing the behavior of industrial production and investment in plant and equipment during the recession to date. The Federal Reserve Index of industrial production fell precipitously from 125.6 (1967=100%) in September of 1974 to 109.8 in March of 1975; over these 6 months the rate of decline was at an annual rate of 23.6% In April and May of 1975 this index continued to fall, but at a much reduced rate; in May the index stood at 109.2. This decline in the rate of fall of the index is one of the major bits of evidence for the concensus view that the recession is bottoming out.

Even as industrial production fell precipitously, fixed investment by corporations in plant and equipment continued at a high pace. The peak in plant and equipment expenditures was in the third quarter of 1974, when it stood at $113.1 billion (annual rate); in the first quarter of 1975, plant and equipment investment had only fallen to $110.1 billions (annual rate). Thus during the recession to date the coming on stream of capacity has been at an all time high rate. This combination of a full 'pipe-line' spewing forth plant and equipment and a sharp decline in industrial production implies a large growth in excess capacity.

Incidently the behavior of investment through the first quarter of '75 indicates that a decline in investment, especially in the non-energy producing sectors of the economy, may occur. Such a decline in investment will act as a damper upon the recovery.

Historically sluggish expansions, such as the one that seems to lie ahead, have been accompanied by low interest rates, rising corporate profits and a sustained upward trend in the stock market. During such periods well conceived and conservatively financed new ventures have often taken strong roots. Paradoxically a tranquil sluggish environment may be better for serious entrepreneurs than a boom. In a sluggish environment well conceived ventures are financed, whereas in the euphoria of a boom almost anything seems to be acceptable and well conceived innovative investments can be crowded out by the popular speculations.

Although a period of modest success seems to be before us, we must recognize that the continued high unemployment will be a festering sore that makes the overall economic situation unsatisfactory. The political pressures to do something - and the willingness of an Administration and a C ongress to do something - about unemployment and the economy's sluggish performance may well become dominant as November '76 approaches. Although well conceived policies can lead to a more satisfactory performance than seems indicated ill conceived actions, such as those of the 1971-2 period, will likely lead to a repeat of the dismal performance of 1973-75 quite soon. Once again tranquility can be expected unless policy is inept.

The Anatomy of the Recession:

The main roots of the recession of 1973-75 lie in financial developments over the past-decade. The recent financial difficulties, that resulted in the failure of three banks with over a billion dollars in assets and the virtual bankruptcy of an entire financial industry - the R.E.I.T.'s, was the third near financial crisis in a decade: the first was the credit crunch of 1966 and the

second was the Penn-Central Commercial paper crisis of 1970. All three financial crises were resolved by appropriate Federal Reserve actions; however the first two were accompanied by relatively mild recessions whereas the third was accompanied by a much more serious - and still continuing - departure from high level activity.

Although much can be made of the war, the vagaries of monetary policy, and the eccentric course of economic policy during the Nixon years the dominant theme running through the 1965-75 decade was the ever more complicated, ever more sophisticated financial practices of both purely financial institutions and corporations. In particular two items - which really are two sides of a coin - can be said to characterize this era. There are the growth of liability management banking - which enabled the giant banks to grow much more rapidly than their equity base - and the increased dependence of corporations upon external finance.

During the explosive inflation of 1973-74 corporations speculated heavily by borrowing largely but not exclusively from banks to finance inventories and investment in excess of their internal cash flows. After the Penn-Central commercial paper crisis corporations borrowed at well nigh unprecedented rates to fund bank debt; the same pattern is being repeated now. After such refunding the pressures from short term debt are abated but the debt payment commitments on long term debt are much greater than in prior periods. Thus each round of increasing short term debts that is followed by a funding of short term debt into long term debt leaves the corporate sector weaker and diminishes the quality of credit that banks acquire in the subsequent expansion.

By 1975 the financial position of many corporations was fragile: their commitments to pay cash was a larger part of their cash flows than ever before as far as available records show. The high interest rates of 73/75 made the carrying costs of bank debt very large. The current decline in short term market rates is quickly decreasing these carrying costs - which by itself strengthens the financial position of corporations. However the only way to really strengthen the financial position of corporations is for their long term investment to become less than the internal funds plus new equity capital they generate. The data in Table I indicates the magnitude of the problem and shows that no substantial progress has as yet been made in this direction.

Until the financial excesses of the early 1970's are liquidated - and the memory of the near miss of a financial crisis is attenuated - we cannot expect a resumption of an expansion that leads to the type of financial instability based recession we are now experiencing. What we can expect is a sluggish and incomplete recovery.

The slackening off of the downward movement is mainly due to the large size of the government and only secondarily to the anti-recession actions by the Federal Reserve and the Government. In this large government, the most significant growth over the post war era has been in government transfer payments. Some time ago much political capital was made of the welfare mess. Welfare payments are but a small (10% or less) proportion of transfer payments; we really have an enormous transfer payments mess. In order to achieve a substantially better performance of the economy we really need reform and rationalization of the entire set of government transfer payments schemes.

Table I

Corporate Fixed Investment, Gross Internal Funds and New Equity

1973 III - 1975 I

Annual Rates / Seasonally Adjusted / Billions of Dollars

period	corporate fixed investment	gross internal funds	new equity	new equity plus internal funds	investment ÷ internal funds & equity
1973 III	110.9	84.8	5.1	89.9	1.23
IV	112.0	86.3	8.9	95.2	1.18
1974 I	112.3	85.3	6.2	91.5	1.23
II	118.0	80.5	5.0	85.0	1.39
III	116.3	75.3	-	75.0	1.54
IV	113.6	84.8	5.2	90.0	1.26
1975 I	111.5	90.7	2.5	93.2	1.20

Source: Board of Governors of the Federal Reserve Flow of Funds data.
Release of May 9, 1975

Transfer Payments; Inflation and Bottoming Out

In Table II data for selected years since 1929 is presented on personal disposable income = the income from all sources that households have to spend, after allowing for personal income taxes and social security taxes, - and government transfer payments. Transfer payments are income in cash or kind that are 'delivered' to households by various government programs: social security, hospital and medical insurance (government), unemployment insurance, government employee and military pensions, veterans benefits, food stamps and direct relief, such as aid to families with dependent children are transfer payments. (Incidently aid to families with dependent children is only 7% and direct relief is only 10% of the total transfer payments. That which is called welfare in the popular discussion is only a modest proportion of total transfer payments).

As the attached table shows, government transfer payments were practically non-existent in the 1920's. Even as we entered World War II, at the end of Roosevelt's Welfare State, they were but 2.8% of disposable income (at the depth of the Great Depression when relief was a pressing matter they were 3.3% of the greatly shrunken disposable income). In 1961, the first year of the Kennedy Johnson era these payments were 8.3% of disposable income, in 1969, the first year of the Nixon-Ford era they were 9.7% of disposable income, and in 1975 I, the latest quarter for which such data is available, they stood at 15.6% of disposable income.

An increase in transfer payments must show up in the mark up over costs of production of consumer goods; a rise in the proportion of transfer payments to disposable income leads to a rise in consumer prices. This is one of the fundamental inflationary pressures in our economy; this is much more fundamental

Table II

Transfer Payments and Disposable Personal Income (Billions of Dollars)
Selected Years 1929-1974
and Quarterly 1974I - 1975I

Year	Disposable Personal Income	Government Transfer Payments to Individuals	Government Transfer Payments - Disposable Personal Income %
1929	83.3	.9	1.1
1933	45.5	1.5	3.3
1941	92.7	2.6	2.8
1950	206.9	14.3	6.9
1960	330.0	26.6	7.6
1961	364.4	30.4	8.3
1963	404.6	33.0	8.2
1969	634.4	61.6	9.7
1970	691.7	75.1	10.9
1971	746.4	89.0	11.9
1972	802.5	98.6	12.3
1973	903.7	113.0	12.5
1974	979.7	134.6	13.7
74I	950.6	123.1	12.9
74II	966.5	130.6	13.5
74III	993.1	138.7	14.0
74IV	1008.8	145.8	14.5
75I	1017.4	158.7	15.6

than money supply changes or government deficits, both of which reflect how these and other government expenditures are financed. Thus the inflationary pressures of the years 1969-74 can be largely imputed to the fact that during these years of presumably conservative government disposable income rose by 54.4% while transfer payments rose by 118.0%. In the recession year 1974 I to 1975 I disposable income rose by 7.0% whereas transfer payments rose by 28.9%

The important economic characteristic of transfer payments is that they constitute disposable income which is not received in exchange for a contribution, either in the form of labor or the services of owned capital, to current production. Thus transfer payments constitute a demand for current output which is not offset by any direct or indirect contribution to the production of output. The demand generated by transfer payments will be reflected in prices of consumer goods; a transfer payment dollar is as good as a wage, salary, or dividend, dollar at the super market.

The reaction of the Government to the recession has been largely to increase transfer payments. As unemployment increases one transfer payment, unemployment insurance automatically increases. Furthermore, people who, though eligible for social security, were working tend to retire. However not only do these automatic effects occur but there has been a positive response during this recession by increasing social security as well as the benefits and duration of unemployment insurance. A permanent government employment program - such as the W.P.A., C.C.C. and N.Y.A. of the depression years-is much to be preferred to the transfer payments route we have taken since World War II, and such a program may be the only way we can get out of

the transfer payment mess.

Our approach to social and economic problems over the past 5 years has consisted of a rather wholesale throwing of money at the problem caused by malfunction of the economy - and this "solution" makes normal functioning worse.

The response we have taken to the recession, the expansion of transfer payments , seems to guarantee that any serious recovery will be accompanied by a rapid rise in the rate of inflation. We cannot as an economy get something for nothing - and the dominant policy approach over the past 6 years has ignored that basic truth.

Thus the size and the increase of transfer payments results in a high floor to the economy's income. Although they induce inefficiency and waste, and are a major causal factor of chronic inflation in good and not so good times, the size and scope of transfer payments make a deep depression virtually impossible. Thus the transfer payment schemes do some good, but at a high price.

In our last trendline we mentioned that our large and increasing dependence on foreign oil meant that any substantial expansion will lead to a huge foreign trade deficit, and this potential deficit, which is deeply implanted in our production processes and so called "life style", acts as a barrier to the achievement of a significant expansion. Thus our reliance on transfer payments leads to a high floor to national income and our dependence on foreign oil leads to a low ceiling to national income. This foreign oil-energy dependent economy combined with our high level of transfer payments leaves us with an economy shich is both constrained on the upside and on the downside.

Economic Policy and the Questionable Capital Shortage

A major theme that is emerging in the current policy discussion is whether there is a shortage of capital, so that full employment of capital still leaves us with substantial unemployment, and whether there will be adequate savings over the next ten years to provide us with the needed resources and funds for investment. Of course the transfer payments schemes tend to decrease savings, decrease labor market participation, and increase unemployment among labor market participants. However the issue of transfer payments has not been confronted directly in this discussion of capital shortages; what has been advanced as solutions are various schemes to increase corporate retained earnings by giving tax breaks to investing corporations, and corporations in general, and by providing some government guarantees to the financing of some preferred type of investments.

There are many questions that can be raised about the reality of a capital shortage and about our need to finance an accelerated pace of investment. A hugh portion of investment funds are siphoned off by energy production, and the trends in technology, both in the production of fossil fuels, and in the nuclear energy mess, are towards ever increasing doses of capital per unit of useable output. It is quite clear that after years of backing and hauling with respect to energy we are now without a policy. The latest government reports have thrown great questions in the way of the technical feasibility of nucleation (independent of the safety factors involved). It seems clear that the costs of energy in terms of the other dimensions of life that will have to be sacrificed to meet current energy demand forecasts, preclude, within present knowledge, the attainment of energy goals unless the country is willing

to be energy rich and poor in the other dimensions of life. Once again there is no free lunch; the question is how are we going to pay for lunch.

The Administration and Congress have both backed off from asking the deep questions about the implications of energy conservation. The Administration in its proposals for the front end of the nuclear energy cycle (the preparation of enriched uranium) intends to privatize this production by giving broad government guarantees against losses from technological, regulatory, or financial factors to the so called private investors. That is the Ford Administration is proposing to induce private investment by guaranteeing the selected investors against losses from almost every conceivable cause, and the F ord Administration is doing this because it will presumably save the taxpayer money and be anti-inflationary. Both reasons advanced by the administration are false. The government guarantee is fully equivalent to a government deficit both in its costs to the taxpayers and in its effect upon inflation.

It is impossible to conceive of a more inflationary government program (unless it is some aspects of the Transfer Payments Schemes) than blanket government guarantees against losses to investing units, and it is difficult to conceive of a program that is more conducive to inefficiency in the choice of production techniques than one which guarantees so called private investors against losses.

Thus even as the recession is bottoming out and even as the economy is constrained against a strong expansion by financial, excess capacity and Balance of Payments considerations, programs are being proposed by the administration which virtually guarantee strong inflationary pressures when a vigorous recovery occurs, as well as a likely selection of inefficient tech-

nique.

Instead of using the serious recession as a reason for critically examination of economic policy the Administration, the Congress, and the public seem committed to additional emphasis upon the very policies that put us in our predicament - that is to transfer payments, energy inefficient technologies and life styles, and an emphasis upon inducing investment.