

POST KEYNESIAN ECONOMICS

A series edited by  
Sidney Weintraub

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**REAGANOMICS**

**IN THE**

**STAGFLATION**

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**ECONOMY**

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Edited by  
**Sidney Weintraub**  
and  
**Marvin Goodstein**



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## Pitfalls Due to Financial Fragility

HYMAN P. MINSKY

The most important economic event of the thirty-five years since World War II is something that as yet has not happened: We have not had a deep and long depression. In the light of the history of the American republic prior to World War II, not having one or more deep depressions over a thirty-five-year period is a radically new phenomenon.

### THE MAJOR NON-EVENT

Somehow the economic and financial institutions, combined with the economic policy regime of the years since 1946, succeeded in fulfilling this major aim of the economic reforms of the Roosevelt era. It is important to acknowledge this success these days for two things are happening. The evolution of the financial structure over the years since the end of World War II, and more particularly since the credit crunch of 1966, has made the economy more susceptible to the type of financial crisis that almost always was part of the historical scenario for a deep depression. In addition, a serious attempt to reconstruct institutions and revolutionize policy is taking place; the ostensible objective of this effort is to eliminate the inflationary thrust that has been evident over the last fifteen years and to modify institutional arrangements and tax structures that, it is asserted, are barriers to efficiency and growth. In terms of economic and human loss a big depression will cost far more than the inflation, or the resource use inefficiency that the combination of high taxes and government regulations may impose. The question that has to be asked is whether the changes being legislated and imposed by administrative edict

make a deep depression more likely by weakening our protective shields against a deep depression.

The era since 1948 rather neatly breaks into two parts. The first part, from approximately 1948 through 1966, was an era of tranquil progress within on the whole remarkable price stability. The second part begins in 1966 and continues to today. It is characterized by increasing financial turbulence, cycles with widening amplitudes, stepwise accelerating inflation, and chronically higher unemployment rates. Although the label "stagflation" may be applied to the era since 1966, we must recognize that this stagflation is also characterized by greater turbulence than the preceding "growth" era. In particular—and this is critical for the view being put forth—there were credit crunches and threats of financial crises in 1967, 1970, 1974-75, and 1980 that evoked special lender-of-last-resort interventions by the Federal Reserve and other government and private institutions, even as there were no such crunches, thrusts, and interventions in the prior tranquil years. See Table 8.1.

Given the emphasis on inflation in today's policy measures, it is significant that the inflation rate during the era of tranquil progress averaged 2.08 percent per year and that the inflation rate over the second, the turbulent, period averaged 6.17 percent per year, almost three times as high. It is this inflation rate—together with significantly higher unemployment rates—that triggered the wave of discontent behind today's legislated restructuring of the economy.

The success of 1948-66 was both striking and unexpected. The common expectation at the end of World War II was that the economy would soon sink into a high unemployment trap such as ruled in the second half of the 1930s. It is important, therefore, for us to understand what was "right" about the economic structure at the end of World War II, and why the era of tranquillity ended and was replaced by an

TABLE 8.1: Implicit GNP Price Deflators, 1948/66 and 1966/80

	1948	1966	1980
Price deflator (1972=100)	52.98	76.76	177.45
Average annual rate of growth of price deflator	1948-66	1966-80	
	2.08%	6.17%	

SOURCE: *Economic Report of the President* (1980), Table B5, p. 239.

era of turbulence. Why was a regime of essentially noninflationary growth replaced by an era of inflationary cycles?

### STABILIZATION PITFALLS

My original subtitle was "Pitfalls of Stabilization Policy in Our Economy." Therefore, we have to understand my meaning of "our economy." Our economy is a capitalist economy which uses complex, expensive capital assets and has a sophisticated, intricate, and ever evolving financial system. The essential characteristics that make an economy "capitalist" are privately "owned" so that the income (profits) earned by capital becomes, in all or in part, private income, and capital assets have a market determined value (price) and this value becomes private wealth. The financial system exists because the ostensible (proximate) owners of expensive capital assets need to finance their ownership by raising funds by issuing some set of negotiable instruments. In dealing with a capitalist economy, we are involved in trying to understand how an integrated production, trading, and wealth-owning system, with a structure of financial claims and commitments, operates through real world irreversible time. In such an economy it is impossible to separate the processes that determine particular outputs, prices and incomes from the financial transactions that determine the commitments of asset holders and the investments that are taking place. Thus the "methodology" of standard economic theory, by which a "nonmonetary" exchange and producing economy is studied in order to derive propositions relevant to our economy, cannot lead to valid propositions for our economy for, without financing relations, capital asset prices are indeterminate. The relation between capital asset prices *and* current output prices is a main factor that determines investment, and investment determines the markups on labor costs that can be realized in prices. Thus relative prices cannot be determined without knowledge of investment's share in output. In particular, the ratio of investment to output determines the real wage, which is the relative price that is most significant politically and socially.

Stabilization policy normally refers to monetary and fiscal measures undertaken to achieve some policy goal. Pitfalls awaiting policy are: (1) the way in which successful functioning of the economy—whether or not due to policy—changes the response to policy measures,

i.e., the behavior of the system, as well as the efficacy of policy changes, and (2) the side effects of policy measures. The stable performance of the economy over the tranquil first period (1948–66) led to the emergence of the fragile financial structure that has characterized the more recent years, creating a policy pitfall. Similarly the ways in which monetary and fiscal responses to inflation lead to the emergence of credit crunches, and the way in which "lender of last resort" and budget deficit response to credit crunches leads, with a lag, to inflation, are pitfalls of policy.

Policy measures reflect a theory of the way the economic system functions. Unexpected side effects reveal the inadequacy of theory. The behavior of the economy since 1966 should be taken as strong evidence that those economic theories which do not explain how the potential for Debt deflation/Deep depressions are "normal functioning" results of the economic process are inadequate. This means that both establishment Keynesianism and monetarism, in either their traditional, naïve, or technically sophisticated rational expectations form, will not do.

### STABILIZATION QUESTIONS

The questions in stabilization policy may well be (1) What is to be stabilized? (2) In the in real world can the objective be achieved? and (3) Can the effectiveness of policy measures change as the structural and institutional characteristics of the economy change? If the answer to the second question is conditional on the stabilization goal, and the answer to the third question is yes, then stabilization policy must always adapt to changing environments. It will be necessary to continuously modify policy rules to allow for the impact of institutional and structural changes.

What is it that stabilization policy attempts to stabilize? The candidates for "stabilization" include the gold/dollars exchange ratio, prices, employment, economic growth, and profits.

Under an international or a unilateral gold standard the policy rule for the central bank is to keep the price of gold in dollars within a narrow predetermined range. As bank liabilities serve as money, the objective of policy becomes to keep bank liabilities in some market-determined ratio to the gold stock, so that bank money and gold coins exchange at par. Otherwise there will be a "drain of gold," from the banks or the central bank. Banks have to be able to reverse this drain;

they must have some power to force the transacting units of the economy to "deliver gold" to the banks.

One of the paradoxes of banking is that a banker has to be rich, even as profitability dictates that the banker has to be fully invested. Being rich therefore does not mean that a banker needs cash in hand; it does mean that the banker is able to force "cash" to flow in his direction without having to pay too great a price in income or wealth.

As Richard H. Sayers showed in his monumentally significant (though neglected) study, *Bank of England Operations 1890-1914* (1936), the Bank of England succeeded in working an international gold standard without inducing serious instability within Britain, because the operations that led to gold drains and gains by the Bank of England centered mainly around the pace of long term (mainly debt) financing in Britain by overseas units. Britain's capital account, rather than the level of activity and prices in Britain, was the slack variable that carried the adjustment burden. As a result, the Bank of England was able to maintain parity between the various currencies and the British pound and between the pound and gold without greatly upsetting Britain's income, employment, and the flow of trade.

### CENTRAL BANK IMPACTS

The effects of various central bank operations upon domestic activity were discovered when actions to protect or disperse gold holdings were taken in environments in which the special investment financing conditions that ruled in the twenty-five years prior to World War I (which Sayers analyzed) no longer ruled. It can be argued that prior to World War I it was Britain that was on a gold standard and that the rest of the world was on a sterling standard. Once the gold standard rules for central bank behavior were implemented in an environment which did not conform to the financial and balance of payment relations of 1890-1914, it was discovered that the quest for external, that is, exchange rate, stability imposed politically unacceptable costs in domestic price and employment instability. In the interwar period the "return to gold" was costly in terms of domestic stability; as a result, it did not last long. Britain went "on gold" in 1925 and "off gold" in 1931.

The post-World War II era of tranquillity reinforces the view that fixed exchange rates can rule only as a transitory situation in which

a special kind of dominance by a financial and economic center exists. As long as the United States could finance a part of its overseas investment by short-term debt issued abroad without causing the holders of such debt to want to cash in their dollar assets, the Bretton Woods System of temporarily fixed exchanges (based upon the dollar as the fixed point) was "viable." Once the liquidity so imposed upon the rest of the world led to significant excess liquidity, with inflationary pressures in the "dependent" countries, the "gold standard without gold" of Bretton Woods was no longer conducive to stable expansion.<sup>1</sup>

Perhaps the major lessons to be learned from both the gold standard and the Bretton Woods era is that the validity of a "policy regime" or "stabilization" objective is conditional upon the institutional structure that prevails. This implies that success, if achieved, is transitory, as long as institutional evolution is permitted to take place.

### LIMITS TO STABILIZATION

When one emphasizes pitfalls in stabilization policy, the concern is mainly with unwanted and perhaps unforeseen consequences of efforts to stabilize the economy. Stabilization policy, even as it succeeds in stabilizing some target of policy, may destabilize other dimensions of the economy which feed back upon and affect the ability of policy to achieve the desired stabilization objective. It is such "roundabout processes" that explain the problems with stabilization policy today. Experience since the end of World War II is evidence for the transitory success of any policy regime. In truth, as the structure of relations within institutions changes in response to the opportunities that arise in any stable regime, "stability in and of itself induces destabilizing changes."

To return to the question of "what stabilization policy stabilizes," the aim in the years immediately after World War II was full employment. The enormous increase in government debt and in money during World War II, as well as the felt need to keep the enormous government debt from declining in value, meant that the ratio of money and near monies to income and to the value of nonmonetary assets was very large indeed in the late 1940s and the 1950s. Yet there was no serious inflation in the years up to the mid-1960s. The inflation that broke out when the Korean War began is ample evidence that the ability to finance rapid inflation was in place, but the asset acquisition, liability-

emission behaviors needed to transform ample liquidity into inflation were missing. The failure of serious inflation to appear in the first twenty years after World War II shows that monetary abundance and monetary growth are not, in and of themselves, sufficient to cause a rapid inflation. Responsible fiscal policy, which means that there is a willingness to tax to finance spending and contain inflation, in the context of a government that is big by prewar standards (although significantly smaller than today's government), can lead to an era of tranquil expansion without significant inflation, in spite of a very high money/income ratio. Monetarists must explain why accelerating inflation was not a problem in this first epoch after World War II even though the money supply was very large and potentially very elastic.

In the Kennedy administration the main objective of economic policy shifted to economic growth. The basic difference between full employment and economic growth as the objective for stabilization policy is that the full employment goal is neutral with respect to the composition of aggregate demand. Consumption demand is just as good in generating employment as investment demand, whereas if economic growth is the goal the policy instruments are used to develop incentives to investment. Ever since the mid-1960s accelerated economic growth has been a major goal of stabilization policy. Perhaps, in a subtle way, the measures undertaken to spur growth actually *retard* growth, induce unemployment, and lead to inflation. These perversities come about because the investments which result from policy inducements are not efficient in generating useful output.

### MODERN INFLATION

Inflation became a serious problem in the late 1960s. After World War II and prior to 1968 the year to year changes in the consumer price index exceeded 3.0 percent only in the "first" post-price control year 1948, in the year the Korean War broke out (1951), and in 1957 (when the rate was a modest 3.7 percent). In the years since 1968 the inflation rate fell below 4 percent only in 1972—the year of price controls—and exceeded 10 percent in 1974, 1979, and 1980.

Economic policy measures aimed to control this inflation for the best part of the 1970s. Not only have monetary and fiscal policy measures been aimed at reducing inflation, but both price controls and wage-price guidelines have been used. Perhaps the reason that antiin-

flation policy has not succeeded is that the theories (and the policy prescriptions that follow from the theories) of the economic policy advising establishment have basically misspecified the way our economy now behaves.

Inflation became a serious problem only after the credit crunch of 1966. The liquidity squeeze of 1969–70 temporarily lowered the inflation rate but inflation soon exceeded the 1966–69 rates. Similarly the Franklin National/Real Estate Investment Trust crisis of 1974–75 led to some abatement of inflation, but in the late 1970s inflation raged at a rate well above that of 1970–74. The hypothesis that the stagflation of 1966 to date is related to the appearance of "credit crunches," and to the policy interactions that follow these crunches, seems to conform with this experience.

We live in an economy in which borrowing and lending on the basis of margins of safety are used to finance both the ownership of durable capital assets and output as it is being produced. Banks are the central organization in the business lending that takes place. Even business access to the open market by way of commercial paper depends upon the issuer having "backup" lines of credit at banks. Banks, in turn, finance their lending by a variety of liabilities including demand deposits (which are bank liabilities), which serve as the primary "money" of our economy. Thus, in our economy, money is mainly the result of bank acquisition of assets. Peering through the veil of the bank balance sheets, we perceive that the "owner" of a bank deposit is financing a variety of activities, but, in truth, deposits mainly finance business. Looking "through the balance sheet," we can also perceive that the units being financed have signed contracts to deliver money, i.e., deposits at banks, to banks when the loan matures. When loans are repayed, money in the hands of the nonbank public is decreased. The lending and then the repayment of bank debts involve the creation and then the destruction of money; the destruction occurs when the borrower repays "money plus interest" to the bank. Any particular rate of growth of the money supply is thus the result of two flows which involve the creation and the destruction of debts and money.

Banks are in the business of lending. They seek to accommodate customers and their sales people instruct business and households in the use of debt. If bank funds are restricted by central bank policy, financing competition will lead both to higher interest rates and to the development of new modes of financing banks and business. But higher interest rates on bank liabilities and on business borrowing imply

lower prices for outstanding assets (whose market prices are the capitalized value of future interest or profits).

The adaptability and flexibility of the financial structure mean that increased demand for financing can be accommodated. This means that the financed demand for the inputs to investment output can exceed the supply of such inputs at existing prices, i.e., inflationary demands can be financed. Efforts by the Federal Reserve to offset such accommodation cause higher interest rates—which can compromise the asset values and safety margins of borrowers. A credit crunch results when financing demands outrun the supplies of funds so that the liquidity and solvency of business units and financial markets are threatened. Often, the “break” occurs when units have to “make position” by tapping some “unusual” or “backup” source. The use of government securities to make position by money market commercial banks in 1966, the collapse of Penn Central and the need for banks to refinance Chrysler from the commercial paper market in 1970, the refinancing of the Franklin National Bank by the Federal Reserve together with the forcing of the REITs out of the commercial paper market and into the banks in 1974–75, and the refinancing of Chrysler (again) and the Hunts in 1980 are examples of “flash points” and embryonic financial crises since the middle 1960s.

Although monetarists emphasize the aggregate money supply and the Federal Reserve as the ultimate “regulator” or “controller” of the money supply, the Federal Reserve was created to be a lender of last resort. The function of a lender of last resort is to refinance organizations and markets whose continued normal operations are deemed necessary if the economy is to avoid deep depressions, whenever these units cannot be financed on commercial terms. The typical problem of a refinancing crisis occurs when the “normal” liabilities cannot be issued either because the borrower cannot meet the market terms (not only in interest payments and protection for repayment of principal but also on the various coverages that are specified in the “words” of a financial contract) or because a market that has been counted on is not working normally. When this occurs, assets have to be sold or the borrowing unit cannot fulfill obligations to the prior lenders who may seek to withdraw their funds in a “run.” Such failure of borrowers to perform in any significant market means that throughout the credit markets a more skeptical view of permissible liability structures and income prospects begins to rule: A shift in the expectational climate which Keynes folded into the concept of liquidity preference has taken place.

Such a shift in preferences that makes liquidity more highly prized makes the terms of debt financing of investment and of the ownership of capital and financial assets more onerous. This leads to a sell-off of inventories and to cutbacks in investment, driving the economy towards a recession/depression. Without the concessionary refinancing provided by the Federal Reserve, the various deposit insurance organizations, Treasury guarantees and consortia of private institutions (that are usually orchestrated by the Federal Reserve), the economy could easily become a victim of the downward spiraling interaction that Irving Fisher in 1933 characterized as a “debt deflation.”

There is a maze of payment commitments on financial contracts in our type of economy which can be validated only if gross capital income—what we can call profits—is sustained. What then determines the flow of profits in our economy?

If we assume a simple (Kalecki) model in which *all* of workers’ wages are spent on consumption, and *all* capitalist profits are saved (and no government or foreign sector), then gross capital income is equal to investment. This simple formula, Profits Equal Investment, tells us that if financial stringency leads to a decline in financed investment activity, then the flow of funds available to validate the debt structures of business will erode; this will reinforce the financial stringency. If the debt-deflation process—a critical element in the development of deep depressions—is to be aborted, the profit flows and thus the debt servicing capacity of business must be sustained even as private investment decreases.

If a government that spends and taxes is introduced into the model—so that we now have consumption, investment, and government—then the gross *after* tax capital income equals investment *plus* the government deficit. If government is small relative to investment, then a rise in the deficit cannot offset a decline in investment. If government is large relative to investment, then a rise in the government deficit can offset the investment swing.

Thus in 1929 Gross National Product was \$103.4 billion, gross private investment was 16.2 percent of the GNP and Federal government expenditures were 2.5 percent of GNP. In 1966 GNP was \$756.0 billion, gross private investment was 16.6 percent and the Federal government was 18.9 percent of GNP. As Table 8.2 shows, gross investment as a percent of GNP has been relatively stable over the years since 1966, even as federal government expenditures, as a ratio to GNP, have risen from 18.9 percent to 22.9 percent in the turbulent years 1966 through 1980.



TABLE 8.2: GNP, Investment, and Federal Government Spending  
(Current Dollars)

	Gross National Product		Gross Private Investment		Federal Government Expenditures	
	\$ (billions)	% of GNP	\$ (billions)	% of GNP	\$ (billions)	% of GNP
1929	103.4	15.7	16.2	15.7	2.6	2.5
1966	756.0	16.6	125.7	16.6	143.6	18.9
1970	992.7	14.5	144.2	14.5	204.3	20.6
1974	1434.2	15.9	228.7	15.9	299.3	20.9
1979	2413.9	17.2	415.8	17.2	509.2	21.1
1980	2627.4	15.0	395.1	15.0	601.2	22.9

SOURCE: *Economic Report of the President* (1981) Table B1, p. 233.

The much higher ratio of government to GNP in the post-World War II era allowed changing deficits to offset the effect on profits of a decline (or a rise) in investment; big government provides a major underpinning to business profits. If business profits are sustained and increased even as private investment tumbles, two things happen: (1) The cash flows to validate business debts are sustained, so that orderly debt liquidation can take place and (2) business remains profitable so that the optimism of businessmen and bankers is soon rekindled. As a result the liquidity-crisis-induced shift in demand is quickly reversed.

We now can understand why we have not had a deep depression. Business profits have been sustained by increased government deficits in the aftermath of each crunch we have identified. This is the hidden facet of the big government and huge deficits of the past fifteen years; they have sustained and then increased profits in the recessions. Although stabilization policy of the post-war years has had income, employment, and prices as its ostensible goals, the essential effect of policy was to sustain profits even when private demand fell in the aftermath of financial crunches and crises.

There are two quite separate elements in the technique that was used since 1966 to stabilize our big-government capitalism that is vulnerable to credit crunches and has the potential for deep enduring depressions. One element is the lender-of-last resort intervention which refinances financial institutions, markets, and business units that are in distress on concessionary terms. This intervention attenuates the

repercussions of distress in some markets upon other aspects of finance; this removes the potential "domino effect." The other element is the government deficit, which sustains business profits even as output, employment, and investment fall.

The policy mix of Deficit-No and Lender of Last Resort-No in Table 8.3 represents the response in the Hoover administration. Between 1929 and 1933 the Federal Reserve so feared inflation that it largely stood aside and did not refinance failing financial institutions in the various crises within the major crisis. At the same time the government, wedded to fiscal orthodoxy, tried to maintain a balanced budget even as income slumped from the 1929 peak.

The Yes/Yes square represents the policy mix used in 1966-81, when the Federal Reserve (and other dependent and cooperating institutions) reacted to financial market crunches with various innovative refinancing measures even as the Federal Government ran a large deficit during the associated recessions.

The other two squares, namely Deficit-Yes, Lender of Last Resort-No and Deficit No, Lender of Last Resort Yes, are as yet untried combinations. The refinancing and income concessions to savings and loan associations and the presumed efforts of the Reagan administration to achieve a balanced budget in spite of the massive decrease in tax schedules make it likely that we may test the Deficit-No/Lender of Last Resort-Yes strategy. If the government persists in trying to balance the budget even as tax revenues decline due to a fall in investment, income, and employment, then the resultant decline in profits will swell the number of organizations that require concessionary refinancing. Although large deficits will occur in spite of the administra-

TABLE 8.3: Policy Combinations  
Lender of Last Resort

		Lender of Last Resort		
		Yes	No	
D E F I C I T	Y e s	D: Yes	D: Yes	D-Deficit
	L e n d e r o f L a s t R e s o r t	L: Yes	L: No	
	D e f i c i t	D: No	D: No	L-Lender of Last Resort
	L e n d e r o f L a s t R e s o r t	L: Yes	L: No	

tion's desires, a Deficit No, Lender of Last Resort-Yes policy mix can lead to a deep and long recession.

The Deficit-Yes, Lender of Last Resort-No strategy does not promise bliss but it may well be the best we can do if getting off of the 1966-82 treadmill is the goal. The strategy allows the Hunts and Chryslers, and even a multi-billion dollar bank or savings and loan association to fail. Furthermore, if financial institutions fail the depository insurance organizations should stick to the letter of the law in making good on deposits. The objective of a Lender of Last Resort-No, Deficit-Yes strategy is to induce balance sheet conservatism by allowing significant failures and losses to occur even as policy aims to maintain the overall cash flows to business. By making liquidity and safe balance sheets valuable, such a policy mix will restrain the portfolio experimentation that leads to financial fragility and demand-generated inflations.

Both the Lender of Last Resort No, Deficit Yes and Lender of Last Resort-Yes, Deficit-No strategies need *not* be absolutist. A pragmatic central bank, which is cooperating in a Lender of Last Resort-No, Deficit-Yes strategy, would stand aside for a time while bankruptcies take place, even as it is ready to intervene to prevent repercussions from initial failures from touching off a string of induced failures. Similarly, if a Lender of Last Resort-Yes, Deficit-No strategy leads to a string of bankruptcies as profit flows decline, a nonideological government will stop trying to "balance" the budget and move consciously to deficit.

The overall topic of every essay is stagflation. I have sketched why periodically we have come to the brink of a financial crisis and a deep depression and explained how a fully realized deep depression has been aborted. Although this period of flirting with disaster and the years characterized as "stagflation" are identical, the links between the periodic threat, and rescue, from financial crisis and depression and the deteriorating inflation and unemployment picture have not been drawn.

In an economy with overlapping contracts and supply prices that are based on costs, inflation has its momentum. Prices and the change in prices can be broken down into unit labor costs and markups per unit of output. Markups on labor costs in consumer goods depend upon the *weight of demands that are not financed by those incomes that are earned in the production of consumer goods*. In simplified models, this is the ratio of total wages and transfer payments to total wages in consumer goods production. In our economy a fall in income and employment leads to a sharp rise in transfer payments to persons. These trans-

fer payments are quickly transformed into a demand for consumer goods. If, as in 1975, profits are sustained, or even increased, when output is down and the economy is in recession, the average markup must rise. This is so for it is the markup on labor costs that carries profits. But if the markup on unit labor costs rises, then the unit price must increase.

In a world with cost of living clauses in wage contracts, and with government transfer payment schemes that are indexed, if wages and transfer payments continue to rise in a recession even as unemployment increases, then both labor costs and the markup will increase. This persistence of inflation will be especially marked if the government deficit is so large as to allow total business profits to increase during a recession. Rising business profits guarantee that a quick economic recovery will take place. However, this recovery will take place in a context of balance sheets which remain fragile and a continuing high rate of inflation. With some upswing of private investment, both income and prices will rise as unemployment falls: but the increased pace of inflation will foster central bank and Treasury actions to "fight" inflation. The wage/price relations in an economy where profits are sustained by deficits are such that during a recovery inflation accelerates; this induces constraining monetary and fiscal measures despite the existence of considerable slack. Constraint is imposed with more unemployment than existed when constraint was imposed the "last time around," in the previous cycle. The stagflation phenomenon, in which inflation and unemployment are positively associated in a step-wise sense, is a normal result in a big-government capitalism in which depressions are stopped from running their full price- and production-deflating course by profit-sustaining government deficits.

We can conclude that stagflation is what results when over some fifteen years, policy, in the form of lender-of-last-resort interventions and government deficits, is used to prevent a debt deflation and an associated deep depression. Instability is a robust characteristic of a capitalist economy for it has survived radical changes in institutions and balance sheet structures. However, what results from instability has changed. Prior to World War II instability led to minor inflations and deep enduring recessions/depressions, in recent years instability has led to serious inflations and short-lived recessions. The processes that led to serious depressions in the past are now *not* allowed to fully function. Combined with active government interventions the relations that make for instability now lead us to stagflation. The inflation of the 1970s was not wholly obscene; it had a redeeming social



virtue for it was a result of the interventions that prevented deep depressions.

Past policy failed not because the economics of Keynes was "wrong" but rather because it was "right." The so-called Keynesian economists of the policy advising establishment ignore financial relations. Monetarists, with their emphasis upon one financial variable, money, which they have trouble identifying in the real world economy, go beyond the "Keynesians" who ignored financial relations, for monetarists deny the significance of financial relations. The view that financial instability is exogenous—or "externally imposed"—is an essential theorem of monetarism.

We fared poorly in the 1970s because policy reflected a set of theories which ignored the rich set of financial interactions that make debt deflations and stagflations normal results. If we are to do better, policy and the legislated aspects of the economy's structure will have to be reconstituted to reflect an understanding of what makes financial relations fragile and how the fragility is brought about. Policy must attenuate the tendency for fragile financial relations to emerge.

The best policy guideline at the present critical juncture is for the Federal Reserve to constrain its intervention as a lender of last resort, so as to induce financial conservatism, even as the government runs deficits, so as to sustain business profitability. With business profitable, income and jobs are also sustained. Stabilization policy will do better only as it is recognized that the policy objectives are to sustain profits and constrain liability experimentation by bankers and businessmen by removing the safety net of premature lender-of-last-resort interventions.

Federal Reserve policy with respect to lender-of-last-resort interventions seems to reflect a belief that the financial/economic structure is now so fragile that any significant refinancing problem can lead to a large scale collapse in asset values. In truth the financial system is not so fragile that any significant failure to perform on financial contracts will trigger an uncontrollable debt-deflation. However, the likelihood that an uncontrollable debt-deflation is set off by a particular failure depends upon the size of the failing unit. The very largest banks, other financial institutions, and corporations are now of such size that it is well nigh certain that the Federal Reserve or the Treasury will intervene to protect the holders of their liabilities. For a Lender of Last Resort-No, Deficit-Yes strategy to be feasible it may be necessary to limit the size of private organizations so that the Federal Reserve could stand aside and allow the liabilities of even the largest private organi-

zation to go into default. One corollary of the argument that has been advanced is that policy with respect to the organization of business and industry determines whether or not a Lender of Last Resort-No, Deficit-Yes strategy can be tried. A quite radical restructuring of finance and industry, so as to increase the weight of the smaller private units in the economy, may be necessary before the Federal Reserve and the Treasury can guide our economy to a closer approximation to full employment at stable prices than we can realize now.

Washington University

#### NOTE

1. These comments on the limitations of gold and the gold standard are prompted by the current push for a return to the gold standard. Unfortunately, the protagonists as well as the opponents of the return to gold know little of what they speak. Their frame of reference is all too often the literature of economics rather than an appreciation of the experience of the gold standard in its heyday.