

A Political-Economic Critique of Minsky's Financial Instability Hypothesis:  
The Case of the 1970 Financial Crisis

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## Abstract

According to Minsky's financial instability hypothesis, financial crises are caused by increasing debt burdens. The purpose of this paper is to argue instead that financial crises are caused by political factors. As such, this paper builds on Dickens (1999), which explains the 1966 financial crisis in terms of class and intra-class conflict. From the perspective of Minsky's financial instability hypothesis, the 1966 financial crisis divides the postwar Golden Age of US capitalism from the current period of recurrent financial crises. By showing in this paper that political factors rather than increasing debt burdens also account for the 1970 financial crisis, I buttress my earlier argument for a revised understanding of the causes of the current period of recurrent financial crises.

For Minsky (2008, pp.73 & 102-104), the 1970 financial crisis was triggered on June 20<sup>th</sup> when the twentieth-largest corporation in the United States—Penn Central Railroad—declared bankruptcy. Minsky argues that the crisis was caused by excessive debt, but to blame bankruptcy on excessive debt strikes me as tautological, not explanatory. Minsky also argues that the principal consequence of the crisis was inflation, largely because the Federal Reserve prevented other capital-intensive firms from meeting the same fate as Penn Central by intervening as lender-of-last-resort. But inflation is caused by unresolved conflict over the distribution of income. To blame it on too much money chasing too few goods is simply incorrect.<sup>1</sup>

In contrast to Minsky, I follow Maisel (1973, pp. 4, 6-7 & 152; and also see Reeves, 2001, pp. 234 & 299) in arguing that Penn-Central's bankruptcy only exacerbated a crisis that began on April 30<sup>th</sup>, when President Nixon ordered U.S. troops to invade Cambodia, and ended on June 30<sup>th</sup> with the passage of the Cooper-Church Amendment to the Military Sales Act, which cut-off funding for the Cambodian invasion and thus forced the withdrawal of U.S. troops from Cambodia. My argument is that Penn-Central's bankruptcy was significant, not because it manifested excessive debt burdens and led to inflationary lender-of-last-resort operations,<sup>2</sup> but because it manifested the end of the New Deal and prompted the Federal Reserve to respond, on June 22<sup>nd</sup>, by permanently eliminating the interest-rate ceiling on the large-denomination time deposits offered by commercial banks.

The 1970 financial crisis was most intense on May 9<sup>th</sup>. The day began with Nixon's predawn drunken stroll among antiwar demonstrators on the Washington Mall. Later in the morning, lieutenants of AFL-CIO President George Meany led union members,

armed with lead pipes and crowbars, in attacks on antiwar demonstrators. The roving gangs of union members then forced liberal public officials to raise to full height American flags flying at half-mast to honor the four antiwar demonstrators killed in Ohio five days earlier, on May 4<sup>th</sup>. By the end of the day, the Dow Jones stock index was below 700, from a peak of 985 in December 1968, and private sources of liquidity had dried-up completely.<sup>3</sup>

Nixon was jubilant, not only because his long-time nemesis—capital-intensive firms entrenched in Wall Street—were now dependent for their very survival on hand-outs from the Federal Reserve, but most importantly because the attacks by union members on antiwar demonstrators was the pay-off he had fervently sought through a two-year-long courtship of AFL-CIO president George Meany (see Reeves, 2001, pp. 215-217, 265, 354, 364, 376-377, 379-381, 392-395, 461-462, 499, and 516-519).

Nixon's decision to invade Cambodia struck many commentators at the time as a mistake. After-all, it was reversed by the Cooper-Church Amendment, and it failed in its ostensible object of stopping the flow of North Vietnamese men and arms to South Vietnam. But such commentary fails to see that everything Nixon did as president was to bring about a domestic political realignment,<sup>4</sup> and that the key to his success at bringing about such a realignment was engineering a change in the ideological commitments of the organized working class.<sup>5</sup> Capital-intensive firms may have been the most articulate faction and major beneficiaries of the New Deal coalition arrayed against Nixon—indeed, seventy-eight percent of the executives at these firms adamantly opposed Nixon and his war-mongering. Nonetheless, the organized working class was the mass base that propelled the New Deal forward. And on May 9<sup>th</sup> the organized working class explicitly

renounced its economic interest in its New Deal alliance with capital-intensive firms in favor of an alliance with the patriotic but labor-intensive and thus largely anti-labor firms arrayed around Nixon's presidency and the Republican Party. Not for the first time in the war-ravaged twentieth-century, the organized working class of an advanced capitalist country chose to identify with a militarized nationalism rather than its own class interest.<sup>6</sup>

Like all government institutions, the Federal Reserve is no more than a barometer of the political forces surrounding it. However, its relative autonomy from democratic accountability allowed the Federal Reserve to respond more quickly than other government institutions to the political realignment engineered by Nixon on May 9<sup>th</sup>. Because of its institutional structure, to the degree that the Federal Reserve is independent of democratic accountability, it is dependent on the commercial banks. Since the mid-1960s, this dependence had taken the form of attempts to preserve the profit margins of commercial banks by providing timely increases in the discount rate to justify a higher prime rate on commercial bank loans whenever the commercial banks bid the yield on large-denomination time deposits to equality with the prime rate. But the behavior of the Federal Reserve in protecting commercial bank profit margins was incompatible with the New Deal financial system of institutions segmented by strictly-enforced rules governing the types of assets and liabilities they could issue, and the rates of interest they could bid and offer on them. For example, only Savings and Loan Associations offered passbook savings accounts at three percent interest in order to make thirty-year home mortgages at a fixed interest rate of six percent. Obviously, the insolvency of the Savings and Loan Associations was assured after the commercial banks were freed on June 22<sup>nd</sup> to bid aggressively for new funds by pushing interest rates on

large-denomination time-deposits to an average yield of more than seven percent then more than ten percent in the 1970s and 1980s, respectively. As the Savings and Loan Associations disintegrated under the weight of portfolios of thirty-year mortgages yielding six percent in the 1970s and the 1980s, when commercial banks had pushed the cost of loanable funds well above six percent, it was the need to bundle their now defunct passbook savings accounts into large-denomination time deposits that first legitimated the reemergence of mutual-fund companies, which had been completely discredited for a generation of Americans because of their central role in the Ponzi schemes that characterized the pre-New Deal financial system.<sup>7</sup>

In sum, the 1970 financial crisis was caused by a political realignment engineered by Nixon through the domestic ramifications of his decision to invade Cambodia, and the principal consequence of the 1970 financial crisis was the Federal Reserve's decision to permanently eliminate the interest-rate ceiling on large-denomination time deposits which assured the disintegration of the segmented New Deal financial system and the re-emergence and consolidation of the pre-New Deal financial system.

#### Endnotes

1. See Dickens (1999) for a more in-depth critique of Minsky's theory of financial crises.
2. After the 1970 financial crisis ended with the passage of the Cooper-Church Amendment on June 30<sup>th</sup>, the Federal Reserve drained from the financial system the liquidity it had pumped in during the crisis with no long-term effect.

3. See Isaacson (1992, pp. 268-275) and Reeves (2001, pp. 215-217) for accounts of the domestic ramifications of the invasion of Cambodia, and Wojnilower (1980, pp. 292-294) and Wolfson (1986, pp. 52-60) for accounts of the drying-up of short-term financing in Wall Street during the 1970 financial crisis.
4. See Perlstein (2008) and Matusow (1998) for evidence that Nixon judged every decision he made as president by the standard of how it would help him bring about the end of the New Deal and the rise of a new conservative ruling bloc. However, Perlstein has little to say about the economic dimensions of the political realignment Nixon envisaged, and Matusow's account of its economic dimensions is marred by his use of a monetarist framework of analysis.
5. Cowie (2002) provides evidence that the shifting ideological commitments of the organized working class were the key to Nixon's success at engineering the political realignment he envisaged. However, Cowie fails to see the role of financial crises in creating the conditions for such fundamental shifts in working-class ideological commitments.
6. See Reeves (2001, p. 215) on the animus of corporate executive toward Nixon and Ferguson (1995, pp. 112-172) for a demonstration of the leading roles of labor-intensive and capital-intensive firms in the conservative and New Deal ruling blocs, respectively.
7. See Homer and Sylla (1996, pp. 388-393) for the interest-rate data and Dickens (1990; 1995) for a more thorough analysis of the issues covered in this paragraph.

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