Minsky and the crisis: 
the Financial Instability Hypothesis 

Alessandro Vercelli 

University of Siena
The Minsky revival

Since the beginning of the still ongoing financial crisis → revival of interest in Minsky’s work

The subprime mortgage crisis was defined from the very beginning a Minsky moment that rapidly degenerated into a Minsky meltdown

In my presentation I will discuss the good and bad reasons of this revival

I intend to argue that the moment of Minsky should not be confined to Minsky moments:

a correct understanding of his far-reaching message may help us to avoid a further Minsky meltdown that could be the big one
The subprime crisis as a Minsky moment

*Minsky moment*: exceptional circumstances of severe financial crisis

Expression coined in 1998 in occasion of the Russian debt crisis by Paul McCulley manager of PIMCO that runs the largest bond Fund → fashionable catch phrase during the subprime crisis, adopted by

• top-level practitioners and analysts (such as Magnus, senior economic adviser at UBS Investment Bank: articles on the FT)

• leading financial journalists (such as Martin Wolf, *Financial Times*; Lahart, *Wall Street Journal*; Cassidy, *The New Yorker*)

• academic economists (such as Whalen, 2008; Wray, 2008; Davidson 2008, Bellofiore and Halevi, 2009, etc.)
Definitions of Minsky moment

- **as a point of time** (consistently with the usual meaning of “moment”):
  - Magnus (2007, FT): “the point where credit supply starts to dry up”,
  - Wolf (2008, FT): “the point at which a financial mania turns into panic”

- **as a process** (short-lived relatively to the periods of financial tranquillity):
  - Lahart (2007, WSJ): “when over-indebted investors are forced to sell even their solid investments”
  - Magnus (2007, FT): “when lenders become increasingly cautious”,
  - Whalen (2008): “credit crunch or Minsky moment”,

consistent: Minsky moment as starting point of a Minsky process
Minsky moment and Minsky process

Minsky moment

To avoid confusion we prefer to distinguish { Minsky process }\[\text{Minsky process}\]

→ Minsky process as a well-defined phase of a financial cycle

→ we need a model of the financial cycle to analyze this phase

→ revisitation of the FIH { only the “core”: the strict financial part updated and somewhat developed }
Minsky meltdown

**Minsky meltdown**: terminology borrowed by nuclear reactor engineering: extremely rare event involving high risks

Definitions:
- McCulley, quoted in Lahart, WSJ, 2007: "a spreading decline in asset values capable of producing a recession"
- G. Magnus, FT, 14.10.2008: "the point where financial instability has become so acute that only an exceptional, immediate and global government attack on the causes of instability is likely to avert a systemic banking failure in which non-financial companies could rapidly fail too"
- Whalen, 2008: “without intervention in the form of collective action, usually by the central bank, the Minsky moment can engender a meltdown, involving asset values that plummet from forced selling and credit that dries up to the point where investment and output fall and unemployment rises sharply”

**Minsky moment**

Difference between { is a matter of degree

Minsky meltdown

**Minsky meltdown**: when the Minsky process is so intense to trigger a deep and persistent recession
Instrumental use of Minsky

Reference to Minsky moments and meltdown as the only possible theoretical endorsement for a policy in contradiction with neoliberal doctrines

maintaining a protective belt around orthodoxy:

mainstream theory for the rule

distinction { Minsky theory for the exceptions: severe of financial crises

very low probability (Greenspan: “once in a century”)

exceptions {

“exceptions confirm the rule”

However, Minsky would not have approved the policies implemented during the ongoing financial crises: destabilizing stabilization because does not address the structural reasons → planted the seeds of a new great crisis

in order to “stabilize an unstable economy” we need structural reforms that prevent the crises and thwart them before the first symptoms emerge
Mainstream regularism

Mainstream economics may be consistently applied only to economic regularities (stationary stochastic processes) (Lucas, 1976, 1981)

→ this justifies in this view equilibrium, stability, substantive rationality, RE, stationarity, weak uncertainty, and so on

Lucas admits that economic phenomena may be sometime irregular

however, they cannot be analyzed by economic Science; however its progress is managing to mitigate irregularities excluding big crises

The success of this approach has contributed to the financial crisis:

- by justifying a declining perception of risk

- by excluding the possibility of a new great crisis: “this time is different”
A broader perspective

We cannot understand and deal properly with a financial crisis if we exclude the crucial role of exceptions (disequilibrium, instability, etc)

“… for an economic theory to be relevant [to policy] what happens in the world must be a possible event in the theory.

On that score alone, standard economic theory is a failure; the instability so evident in our system cannot happen [in standard theory]” (Minsky, 1986, p.290)

→ we need a more general vision: both regular and irregular phenomena: accounts also for the exceptions

Minsky’s approach {
  explains the transition from rule to exceptions
Minsky’s theory (1)

Minsky’s theory is a re-interpretation/updating/extension of Keynes’ *General Theory* (*GT*): we have to mount “on the shoulders of the giant to see better”

**Re-interpretation** because the mainstream interpretation of the *GT* (“neoclassical synthesis”) is believed to be flawed:

- **Full-employment equilibrium** assumed to be stable (Don Patinkin: stable but slow convergence): Minsky instead: “*stability is destabilizing*” (1975:12)

- **Uncertainty** (to be sharply distinguished from risk) does not play any role
  Minsky: “Keynes without uncertainty is something like *Hamlet* without the Prince” (1975: 57)

- **Profits** and income distribution do not play an essential role in the model:
  “workers spend what they earn, while entrepreneurs earn what they spend”
  Kalecki:  \( P = I \) under general simplifying assumptions, interpreted as \( P \leftarrow I \)
Minsky’s theory (2)

Extension: Minsky shows that these three basic shortcomings depend on the complete neglect of the crucial role played by financial conditions in a “sophisticated monetary economy”

this is the most original and far-reaching contribution: the recovery and extension of Keynes’ insights on the intrinsic instability of a “monetary economy: “Financial Instability Hypothesis” (FIH)

Updating: capitalist system as an evolutionary system:
  barter economy: mainstream economics
  monetary economy: GT

Minsky’s further updating: the FIH focuses on a “sophisticated monetary economy”
Minsky’s theory is not a complete macroeconomic theory but a blueprint for an alternative theory combining three main ingredients:

(i) **The core of FIH:** the study of the financial conditions of a sophisticated monetary economy and their fluctuations leading to business cycle, crises and, more rarely, great crises (“Minsky’s meltdowns”)

(ii) **A financial theory of aggregate investment** combining the core with Keynesian (GT) and Kaleckian (“the theory of growing risk”) elements

(iii) **A macroeconomic accounting based on Kalecki’s identities:**

\[ P = I + (G-T) - (E-M) + cP - sW \rightarrow P = (1-c) [(G-T) - (E-M) - sW] \]

*G-T:* public deficit; *E-M:* trade balance deficit; 
*cP:* consumption from profits; *sW:* savings from wages
The core of FIH: a restatement (1)

I have only time for a critical exposition of the core of FIH

**economic units**: “every economic unit – an enterprise, a household, a financial institution or the state- is a device of inflows and outflows of money” (Minsky 1982: 40) → every economic unit is seen as a “bank”

We may define:

- \( e_{it} \): financial outflows (“expenditure”) of a unit in a period of time
- \( y_{it} \): financial inflows (“income”) of a unit in a period of time

Minsky starts his numerous versions of the FIH from a classification of economic units from the point of view of their financial conditions

- hedge
- speculative
- non-hedge { Ponzi }
A suggested classification of financial units

Each financial unit is characterized by a pair of values: $k_t$ and $k_t^*$ that define its liquidity and solvency conditions at time $t$.

I restate the two indexes as ratios:

**liquidity ratio**: excess (or net) financial outflows: 

$$k_{it} = \frac{e_{it}}{y_{it}}$$

**solvency ratio**: net worth of unit $i$: 

$$k_{it}^* = \frac{\sum_{s=0}^{n} E[e_{it+s}] / (1 + r)^s}{\sum_{s=0}^{n} E[y_{it+s}] / (1 + r)^s}$$
Fig. 1: classification of financial units

- Region 1: hyper-hedge
- Region 2: speculative
- Region 3: hyper-speculative (Ponzi)
- Region 5: highly distressed
- Region 4: hedge
- Region 6: distressed
Financial instability hypothesis: a model

We are now in a position to restate the core of the FIH with the aid of a simple model interaction between the liquidity ratio and the solvency ratio (cash-flow approach),

\[
\begin{align*}
\frac{\dot{k}_{it}}{k_{it}} &= -\alpha_i \left[ k_{it}^* - (1 - \mu_i) \right] & \alpha > 0 \\
\frac{\dot{k}_{it}^*}{k_{it}^*} &= \beta_i \left( k_{it} - 1 \right) & \beta > 0
\end{align*}
\]

The importance of this feedback is emphasized by Minsky:

“though textbooks may consider solvency and liquidity as independent attributes the two conditions are interconnected” (Minsky, 1982: 205)
Definition of Minsky moment and Minsky process

This Lotka-Volterra model produces clockwise cycles that have properties very similar to those described by Minsky in the FIH expansion; 2 boom; 3 crisis; 4 recovery
Equilibrium is de-stabilizing

equilibrium is destabilizing: tranquility at \( \omega \) shifts the safety margin starting the cycle
Financial fluctuations: persistent disequilibrium, dynamic and structural instability

Further rightward shifts of the safety margin push the representative point on larger orbits increasing financial fragility.
The ongoing financial crisis: insights from Minsky

Generally the evolution of facts makes theories obsolete

this is not the case of the FIH →
the evolution of facts made this approach progressively more important:

**growing importance of finance:**
- the ratio between financial and real assets (as measured by the FIR of Goldsmith) grew from < 1 at the beginning of the 1980s to > 3 today
- GDP share of FIRE increased to 12%
- share of profits about 40% in 2007

non-financial firms

this is true also for { household shares, ↑pension funds

→↑ scope { theoretical of the FIH empirical
Policy implications

The approach outlined may guide us to draw

to get out of the crisis

policy implications {
  to avoid that “it” may happen again
}

After the great recession:

black swan: unpredictable event (“once in a century”)

two viewpoints {
  grey swan: recurrent event (phase of a recurrent cycle)
Increase of the liquidity reserves constraint

\[ k_t \]

\[ 1 \]

\[ 1-\mu_t \]

\[ 1-\mu_t+\theta \]

\[ 1 \]

\[ 1+\theta \]

\[ k^*_t \]
The “grey swan” view

Grey swan view: this approach shifts the attention towards systematic and continuous prevention through

“big government”: stabilizing (counter-cyclical) effect

Institutions { powerful central bank: lender of last resort

Counter-cyclical policies insufficient: fine tuning is impossible

liquidity constraints

ceiling to the financial cycle { leverage constraints

→ cap to financial fragility
Liquidity and/or leverage constraint
Policy implications:
topicality and up-to-dateness of Minsky

To come out of the crisis in a sustainable way we need “fundamental institutional changes similar in scope to the basic reforms of the first six years of the Roosevelt presidency” (Minsky, 1986: 5)

“We must develop economic institutions that constrain and control liabilities structures, particularly of financial institutions” (ibidem)

→ “We can … stabilize instability”
(Minsky, 1986: 10)

The way out is seen in structural reforms that go in a direction opposite to that advocated by the troika (strengthen the market and weaken all public institutions):

• Full employment policies co-ordinated by public institutions for a more “humane” society; however “minimum of administration” to regulate markets

• Precondition: “finance cannot be left to free markets”
(Minsky, 1986: 292)
We have to regulate finance in such a way to reduce its weight in the economy (Rogoff: about the same size of the ‘1970s: 1/3d)

- **Dimensional cap to private FI**: the leading FI are “too big to fail” and “too big to be bailed out”; avoid: “privatization of profits and nationalization of losses”
  
  Greenspan: graduated capital requirement → useful but insufficient

- **Cap to deficit and/or leverage** to stabilize financial fluctuations (Geanakoplos, 2010; Adrian & Shin 2009)

- **Tax on financial transactions**: proceedings to support employment and the real economy along the lines of sustainable development (T. Matheson, IMF, 2010), already adopted by 23 countries.

- **Segmentation**: updating the Glass-Steagall act (1933) to stop contagion and to avoid conflicts of interests (Kregel, Orléan…)

- **Separation** between revision of balance sheets and consultancy (rating agencies still play both roles: conflict of interest)
Structural interventions (2)

To reach the goal we need a much improved regulation and supervision of markets:

new regulation and supervision rules for existing regulating institutions

… and sheer repression:

- offshore financial centers

first of all of shadow finance { - OTC derivatives
- off-balance sheet operations

I am aware that these recipes may look utopian

however a vigorous process of de-financialisation already happened in recent history as a reaction to the Great Depression (1933 bank law and Glass-Steagall Act) and this initiated a period of unprecedented growth and financial stability
Structural interventions (3)

Main objection: negative impact on growth

**but** the reduction of expected financial profits would shift investment away from the financial sector and back to the real sector improving employment

Minsky criticizes the obsession for growth in name of a “**humane economy**”:

”The emphasis on…”economic growth” rather than on employment as a policy objective is a mistake.

A full-employment economy is bound to expand, whereas an economy that aims at accelerating growth… not only may not grow, but may be increasingly inequitable in its income distribution, inefficient in its choices of techniques, and unstable in its overall performance” (Minsky, 1986: 292-293)

Therefore public policy authorities should play the role of “**employer of last resort**”

**Policy strategy opposite to that of austerity!**
The legacy of Minsky

In the absence of drastic measures of this kind we may experience soon other major waves before the Great Recession comes to an end or we may precipitate soon in a new Great Crisis

I think that we have to find the courage of implementing the drastic reforms mentioned above both in economic theory and in economics before it is too late:

before the “big one” happens…
Thank you for the attention
References


References


References


