

30-31 October 2009 Berlin Conference  
Research Network Macroeconomics and Macroeconomic Policies

**"The World Economy in Crisis: The return of Keynesianism?"**

---

## **Minsky, Keynes and financial instability: the recent sub-prime crisis**

*Elisabetta De Antoni, University of Trento (Italy)*

This presentation envisages **3 steps**:

**1. The Working Hypothesis:**

*Minsky and Keynes had different **subjects of analysis**;*

**2. A Test of the Working Hypothesis:**

*this led them to different **conceptions of the trade cycle**;*

**3. Concrete Implications:**

*Minskyan and Keynesian aspects of **the recent financial crisis**.*

- 1. The different subjects of the analysis

**Minsky** proposed himself as an interpreter of *The General Theory*.

### Our view

Despite the shared view, there are important differences:

**Keynes** experienced the tragedy of the **Great Depression**;

**Minsky** was formed by the hopes for **post-war renaissance**.

- This inevitably left its mark!

**MINSKY's** main problem is the tendency of his economy to **OVER**-indebtedness and **OVER**-investment.

*“The spectacular **panics, debt deflations, and deep depressions**....as well as the **recovery**....are of lesser importance....than the developments over a period characterized by **sustained growth that lead** to the emergence of fragile and unstable financial structures’” (1986:173).*

**KEYNES'** main problem is the tendency of his economy to **UNDER**-investment and **UNDER** employment.

*Thus, Keynes stresses the chronic inadequacy of investment with respect to full employment, the need to support the economy always and anyhow....*

## The different subjects of the analyses:

**KEYNES** (1936) looked at a **stagnant** economy prone to the exhaustion of profitable investment opportunities.

**MINSKY** (1975, 1986) looked at a **vibrant** economy with optimistic profit expectations and a high propensity to borrow and to invest.

## 2. A Test of Our Working Hypothesis

Let us compare the conceptions of the cycle underlying:

- Minsky's (1975, 1986) '*Financial instability hypothesis*'
- Keynes's (1936, Chapter 22) '*Notes on the trade cycle*'

### The upswing

In **MINSKY**, the excess of planned investment over (firms') saving is so great that it inevitably requires **indebtedness**.

*Finance is at the centre of Minsky's architecture.*

**KEYNES** does ***not even mention firms' indebtedness!***

*Given the smaller excess of planned investment, producers may have sufficient own resources to finance it.*

## ■ The weak point of the upswing

- The upswing improves expectations and confidence;
- the consequences, however, are radically different.

In **MINSKY**, optimism stimulates **indebtedness** to the point where firms' debt commitments rise above profits.

*Growth endogenously leads to financial fragility.*

In **KEYNES**, indebtedness is not even mentioned. Keynes's problem is the increasing divergence between the rising expected – and the falling actual – **yields on investment.**

## The Peak

The crisis is '*financial*' in Minsky and '*real*' in Keynes.

In **MINSKY**, growth eventually turns into an increase in the interest rate that – in the context of financial fragility inherited from the boom – triggers the financial crisis.

- *Firms' debt commitments can no longer be fulfilled in the ordinary way (liquidity balances, profits or borrowing). They now require the sale of asset.*
- **KEYNES** expressly rejects such a diagnosis: it is the inevitable disappointment of the over-optimistic profit expectations that provokes the crisis.
- *“But I suggest that a more typical, and often the predominant, explanation of the crisis is, not primarily a rise in the rate of interest, but a sudden collapse in the marginal efficiency of capital” (1936:315)*
- In **MINSKY**'s vibrant economy, the upswing may attain or even surpass full-employment.
- In **KEYNES**' stagnant economy, the upswing tends to stop before: the m.e.c. is generally insufficient to ensure f. e.

## The downswing

In **MINSKY**, the crisis reveals the need to reduce the over-indebtedness inherited from the boom.

*In his vibrant economy, the downswing somehow performs a **cathartic** role:*

*it restores the robustness of the financial system, paving the way for the ensuing recovery.*

In **KEYNES**, the crisis turns the boom's over-optimistic profit expectations into the contrary 'error of pessimisms'.

*In his stagnant economy, recessions and depressions have **no cathartic** or beneficial effect:*

*'they belong to the species of remedy which cures the disease by **killing the patient**' (1936: 323).*

## The trough

In **MINKSY**'s vibrant economy, the lower turning point is not open to question.

According to his '**upward instability proposition**':  
*'any transitory tranquillity (under-employment eq., general eq., steady growth) is transformed into an expansion'*  
(1986: 119).

*Tranquillity increases confidence and this stimulates externally-financed investment.*

In **KEYNES**' stagnant economy, there is no upward instability.

*The main message of the first 21 chapters of Keynes' book is precisely the **possible persistence of the slump**.*

To sum up, **Minsky** (1975,1986) and **Keynes** (Ch. 22):  
-focused on two *different economies*  
-and thus came to different conceptions of the *trade cycle*.

### In our view

**Minsky's** upward instability prop. is not necessarily true:  
*calm may also persist for ever.*

**Keynes's** theory seems to be more correct:  
*the increase in confidence due to tranquillity does not stimulate the economy if expected profits are zero or negative!*

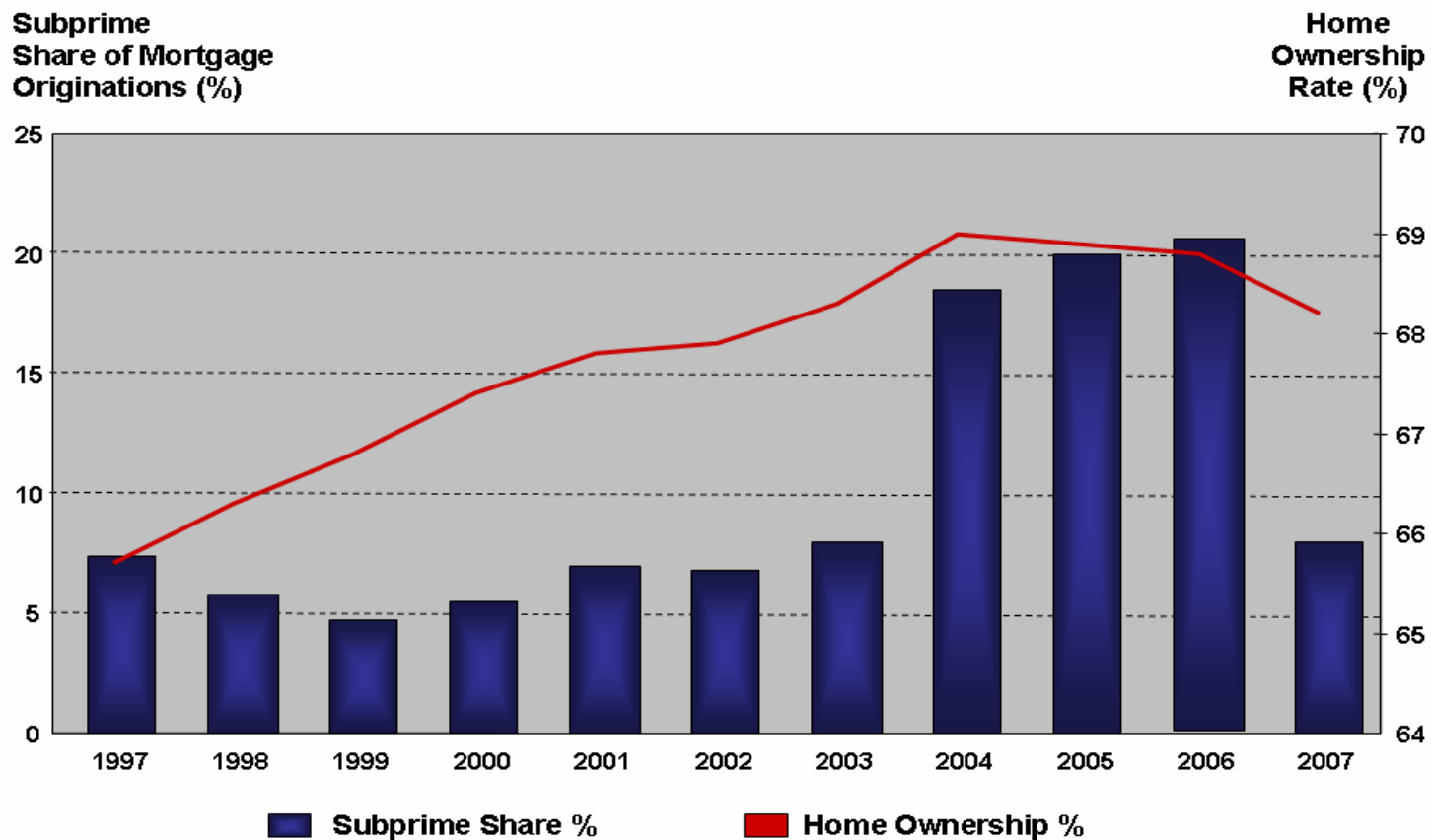
**Keynes's** theory seems to be more general:  
*in addition to the trade cycle, it also envisages the persistence of the slump.*

### however

**Minsky** had the great merit of expliciting the crucial role of finance and of financial instability

- This is the sub-prime share of mortgage originations:
- **three years were enough** to bring the US financial system (and the world economy) to its knees!

U.S. Subprime Lending Expanded Significantly 2004-2006



Sources: U.S. Census Bureau; Harvard University- State of the Nation's Housing Report 2008

### ■ 3. The subprime crisis

The literature is probably right in interpreting the recent financial crisis as a “**Minsky moment**” followed by a “**Minsky meltdown**.”

Our question goes beyond the episode in itself:

**-does the recent crisis fit with the ‘core’ of Minsky’s financial instability hypothesis?**

We refer to the theses:

- i) that capitalism is **endogenously** prone to growth;
- ii) that growth in its turn **endogenously** leads to financial fragility, financial crises, debt deflations and deep depressions.

The two theses are both fundamental to Minsky`s construc..

-As we have seen, the tendency to growth (the upward instability proposition) seems highly questionable.

-What about the tendency of **growth towards financial instability?**

The recent turmoil

**The 2000s over-indebtedness was not the consequence of real growth.**

*It was the result of the Fed`s policy, of deregulation and of innovation.*

**The 2000s over-indebtedness was rather the cause of growth.**

*Minsky`s over-indebtedness is rooted in the investments-profits-investments upward spiral. In the early 2000s, productive investments were at a standstill.*

*It was the increase in credit availability that triggered the boom of households expenditure, thus reactivating growth.*

To sum up, the sub-prime crisis does not seem to confirm the second pillar of Minsky's financial instability hypothesis.

- The recent US experience might rather confirm **Keynes' stagnationist approach:**
  - *after all, in spite of the exogenous support from the Fed, financial deregulation and innovation,*
  - *the American economy has failed to prevent a new depression.*
- In this perspective, **Minsky's** contribution would consist in showing that finance can sustain and prolong growth, but not prevent (indeed, even accentuating) the collapse.

More generally, Minsky`s main contribution consists in questioning the myth of growth led by private investment.

In his view, this kind of **growth**:

- **does not tend to a uniform and constant rate,**
- but instead turns into financial crises, debt deflations and deep depressions.

*“an economy that aims at accelerating growth through devices that induce capital-intensive private investment 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” (1986: 292).*