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

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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 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.
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).*
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’


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!

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**U.S. Subprime Lending Expanded Significantly 2004-2006**

![Graph showing the subprime share of mortgage originations and home ownership rate from 1997 to 2007.](image_url)

*Sources: U.S. Census Bureau; Harvard University- State of the Nation's Housing Report 2006*
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 construction.
-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).