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“The World Economy in Crisis: The return of Keynesianism?”

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 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!

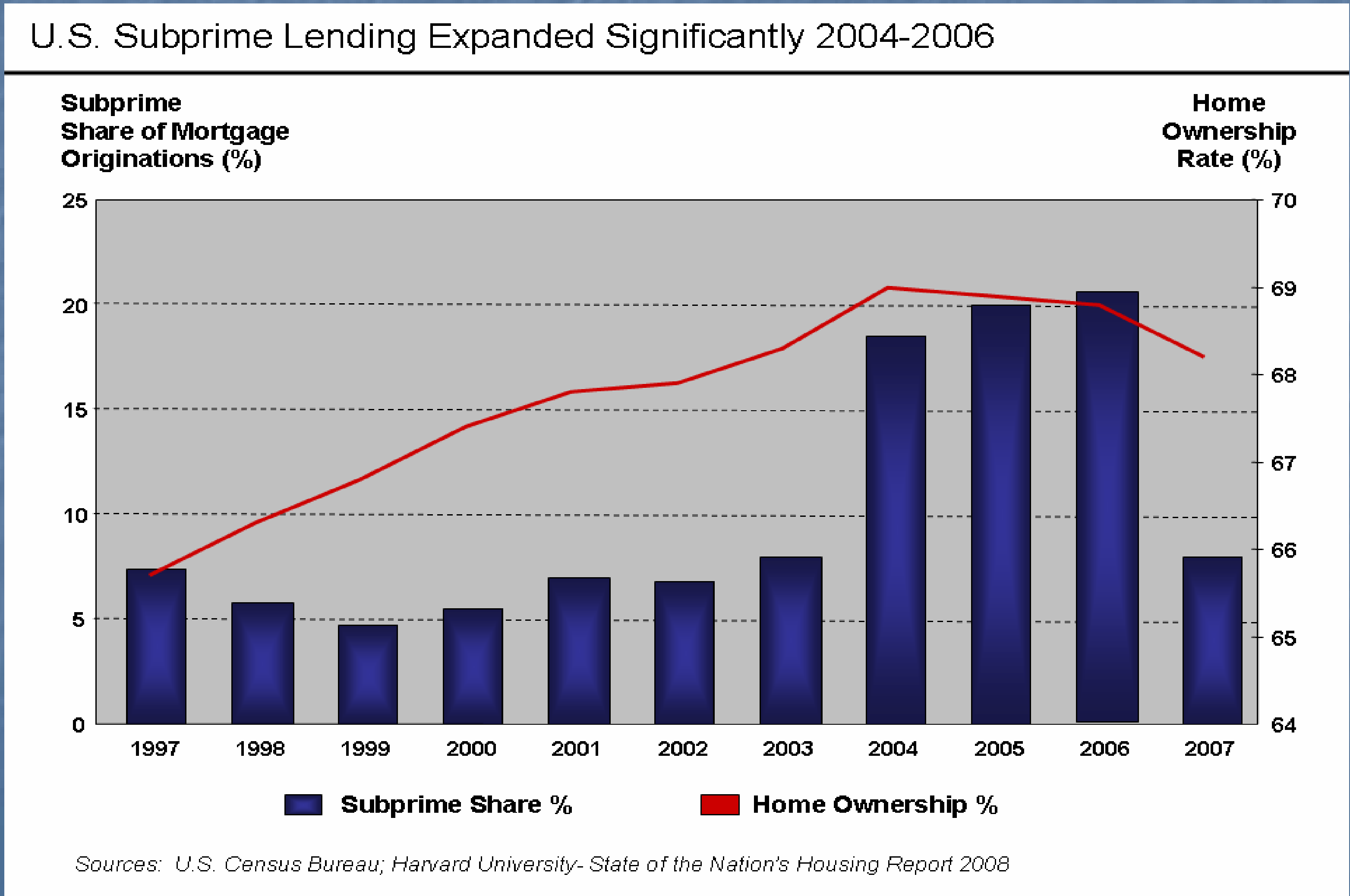
Keynes's theory seems to be more general:

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!



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).