Minsky's Big Bang Theory

When nothing goes right in explaining economic reality, go left. As mainstream macroeconomics largely failed to predict the largest recession since the Great Depression and have not yet converged on a full explanation of its causes, many turn to heterodox economic theories to make sense of the reality we are witnessing. And few macroeconomists have been more heterodox than Hyman Minsky, the man who stands behind economics' most famous oxymoron "Destabilizing stability". Almost three decades after his most significant contribution – Stabilizing an Unstable Economy – his Big Bang theory of debt markets is gaining momentum. Who was Minsky and can his views help us to understand the present crisis?

Born in 1919, he earned his PhD from Harvard University under the influence of another great 20th century economist, Joseph Schumpeter. Growing up during the Great Depression he was primed to spend his career studying the causes and consequences of financial crises.

Modern macroeconomics largely view the economic system as a self-stabilizing system and look for the causes of crises in poor institutional design (such as the implicit government support for subprime mortgages through semi-government institutions or the implicit subsidy inherent when the government bails out banks deemed "too big to fail") or external shocks (such as the oil shocks of the 70s). Minksy on the other hand was a firm believer that modern economies were fundamentally unstable as he wrote in 1974: "A fundamental characteristic of our economy is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles".

This Financial Instability Hypothesis relies upon a cash-flow approach to investment assuming inherently irrational expectations of agents. The gist of his theory is that a sustained period of stability gives rise to optimistic expectations and a rise in speculative financing (calling upon the psychological notion of "success breeds daring"). According to Minsky, the debt structure of the economy undergoes three stages in which most financial lending is of one of three types: hedge (not to be confused with a hedge fund), speculative and Ponzi. The hedge borrower can make debt payments (covering both interest and principal) from current cash flows from investments. The speculative borrower can cover the interest from current investment cash flow to service the debt, but must regularly roll over the principal. The Ponzi borrower can only cover the interest rates by increasingly extending his borrowing.

Minsky's analysis starts during a time immediately after the end of a financial crisis. With a recent crisis in mind investors are careful and most investment is of the safe 'hedge' type. As these returns turn out well, investor confidence rises and an increasing amount of investment becomes of the 'speculative' type: more risky, but not inherently unprofitable. Finally, as the last crisis has faded into distant memory and almost all investment is seen as profitable. The economy moves into its 'Ponzi' style phase and small shocks can send it over the edge. The system can become so fragile that even the most miniscule shock, e.g. a rumor from the FED that short interest rates will increase, can cause the whole system to collapse. As reality meets the irrational expectations, we undergo a rush to liquidity, contemporaneous drop in asset prices (both financial and real) and a drop in investments that exacerbate the financial crisis. This collapse, often referred to as the Minsky moment, has a domino effect to the extent that even within healthy hedge borrowers, deleverage becomes the common denominator (picture 1). Minsky concludes by oxymoronically calling this the “destabilizing effects of stability”- indeed the financial system self-weakens itself.

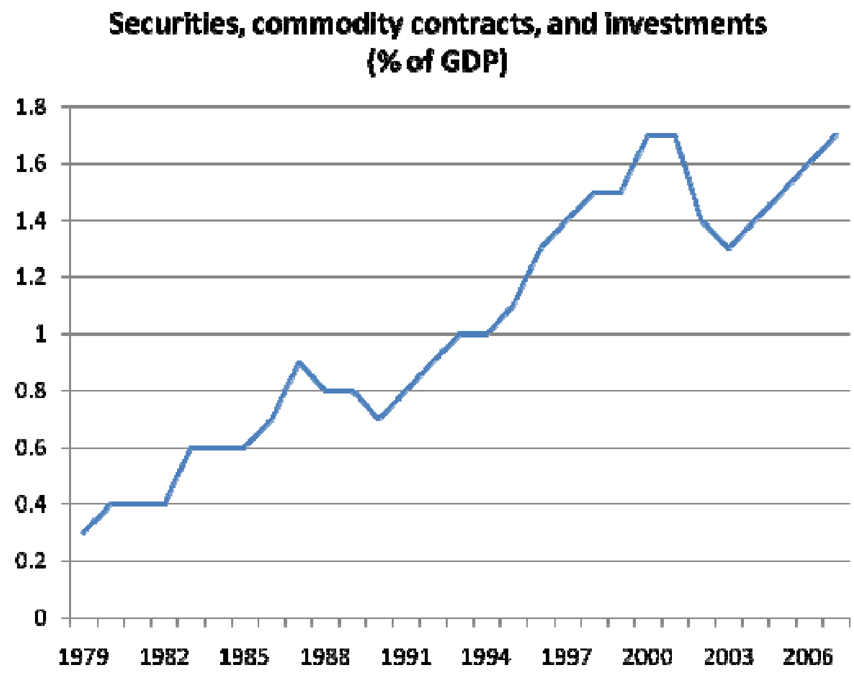
Picture 1. The Minsky Moment

“Of course, you could try another bank, if there were any other banks.”

Source: New Yorker Cartoons

Thinking about Minsky’s theory, it seems straightforward to draw an analogy to the recent collapse of the U.S. (and global) financial market. As the memory of the last U.S. recession waned by 2000s, the processes of financial innovation, deregulation and optimism induced increased appetite for risk, enabling the financial system to raise debt ceilings and leverage (picture 2). By mid 2006 the market had reached its peak Ponzi stage, and slowly by late 2006 the smarter of the traders started to cash in on their profits. Shortly thereafter Lehman went under and all else is very familiar history. Some might see an analogy with the recent on ongoing Eurocrisis.

Picture 2. Securities, commodity contracts and investments (% of GDP)



Source: U.S. Bureau of Economic Analysis

So what does this mean? Should we abandon standard economic theory in favor of Minsky's framework? Should we severely constrain the financial sector in order to rein in its inherent fragility? Maybe, but the Minsky story makes it difficult to know for sure. The main problem is that he takes a narrative approach to macroeconomics. This is surely fine as a starting point, but without a formal framework it is impossible to properly test his theory for internal consistency and empirical validity. This means that any reader so inclined can make Minsky's framework fit with any situation of financial crisis and a theory that can predict anything predicts nothing.

This however, does not mean that important psychological approaches to economics should be left off the table. One thing that we can surely take home from this is that one should read the history of Economic thought. Economics was not a tabula rasa prior to its mathematization in formal models, and there are interesting theories lying under the dust of library shelves that have been too easily labeled as radical or heterodox theories. Minsky's behavioral approach could surely inspire some utility function modeling, but if we seek to make any progress these most be grounded in the same formal rigor as the rest of economics.

References:

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