Lecture 3

MINSKY AND THE FINANCIAL INSTABILITY HYPOTHESIS

Lectures in the Theory of Interest and Monetary Policy

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Summary

1. Introduction

Hyman P. Minsky 1919-1996

- Minsky's Politics and Keynesianism

- Influence of Henry Simons (1899-1946) Oskar Lange (1904-1965) and Joseph Schumpeter (1883-1950).

Methodology

- Real vs. money/credit economy

- General Equilibrium vs. Disequilibrium, with stabilising mechanisms (credit) periodically breaking down in business cycles.

- Microeconomic foundations in balance sheet operations of firms, households, state (see Richard Koo).

  → 'debt structures'

2. Credit Operations

- Dual Price System of Irving Fisher:

    Current Trade 'extinguishes liabilities'

    vs. trading future claims & obligations in credit markets.

Standard microeconomics deals in *Current Trade* (Keynes's *industrial* circulation of money).

Minsky's balance sheet approach

- Firms (also households, banks and governments) summarise *future* claims and obligations in their *balance sheets*:

→ Balance sheet as a set of 'dated future payment claims and obligations.

- *Assets* show sources of future revenue that is used to pay future obligations in *liabilities*; i.e., *financial* circulation of money.

Liquidity

- Liquid assets (bank deposits, foreign currency) needed to assure payment of obligations due today (if revenue from assets is insufficient).

- Illiquidity: economic unit does not have today sufficient revenue or liquid assets to cover payments due today.

- **Firms go into liquidation not because they are making a loss, but because they become illiquid!**
- **(Standard economic justification of profit-maximisation is wrong!)**

Illiquidity vs. Insolvency

- Illiquidity means not being able to pay today's bills (payment obligations).

- Insolvency: Value of assets **<** Value of liabilities.

If Value of assets – Value of Liabilities > 0 = Retained profits (added to reserves);

If Value of assets – Value of liabilities < 0 = Losses (deducted from reserves)

3. Financing structures

Cash flow (generated from assets/issue of *future* liabilities)

    = sales revenue – production costs

    - payments on existing financial obligations (debt + equity)

    + sales of assets

    + issue of new debt/equity

'Hedge' finance

- future income covers payments at all times.

- e.g., banks 'hedge' deposit interest payments by lending at floating rates of interest

  so that higher deposit rates are covered by higher borrowing rates.

'Speculative' finance

- future income may be < payments, but overall income is expected to be > payment commitments.

e.g., bank lends at fixed rate; may cause temporary cash shortfall. But eventually the financing 'position' is profitable.

'Ponzi' finance

Income is always less than financing costs, and can only be met by issue of new obligations/sale of assets.

So Liabilities increase without increase in assets.

e.g. 'pyramid' banking, borrowing to cover unexpected losses.

(named after Charles Ponzi, Boston 'pyramid' banker of 1919 – 1920)

4. The Financial Instability Hypothesis 1

- 'Displacement' sets off investment boom.

- Boom → rising indebtedness.

- Financing structures deteriorate ('hedge' finance becomes speculative; 'speculative' finance becomes 'Ponzi')

  → crisis.

5. The Financial Instability Hypothesis 2

Sales revenue – production costs = operating profit.

Operating profit – payments on financial obligations (debt/equity)

  = Retained Profits.

Net Cash flow = Retained Profits + sale of assets

+ issue of new financial obligations.

In Aggregate (Kalecki's theory of profits)

Saving (retained profits of firms + household saving)

   = Firms' Gross Capital Formation (investment)

   + Fiscal Deficit (Govt. Expenditure – Revenue)

   + Trade Surplus (Exports – Imports).

Assume balanced budget and foreign trade: S = I

S = I

Saving = Firms' saving (retained profits) + household saving = Investment

Investment is procyclical.

So profits (in aggregate) rise and fall with cycle (Josef Steindl)

Inherited debt structures

In each period, firms' profits depend on their investment (and capitalists' consumption).

But debt structures (liabilities) are inherited from past. Cannot easily be changed quickly (Investment banking).

Financial liabilities become excessive

- When investment falls, triggering fall in aggregate profits/net cash flow.

- Fall in aggregate profits exposes over-indebtedness. Financing structures deteriorate.

6. Financial Instability Hypothesis 3

Firms hold liquid assets (bank deposits, bills) as reserves

Extended Tranquillity (absence of crisis)

→ Reduced 'Cushions of safety' (holdings of liquid assets)

→ cash flow problems more likely.

'Minsky Moment'?

7. Policy Implications

'Big Government' & counter-cyclical spending.

Interest rate and financing structures.

Lender of last resort ('Big Bank').

8. Criticisms

- Industrial crisis (investment failure → 'non-performing loans')

  affecting banks,

  vs. banking crisis affecting companies

  (A criticism also of the application of Minsky to the present crisis).

- Kalecki's profits theory based on national income identities.

- Gross vs. net debt.

- Equity vs. debt boom of recent years.

- 'Self-financing' investment.

- U.S. focus/Application to developing countries, or countries with banking vs. capital market systems.