9-1987

Review of "Financial Crises and the World Banking System"

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est rate policies and foreign debt in developing countries.

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REFERENCE

IQBAL, ZUBAIR AND ABBAS, MIRAKHOR. *Islamic banking.* Washington, DC: International Monetary Fund, Occasional Paper 49, Mar. 1987.

Financial crises and the world banking system. Edited by FORREST CAPIE AND GEOFFREY E. WOOD. New York: St. Martin's Press. 1986. Pp. x, 270. $29.95. ISBN 0–312–28946–4
JEL 86–1084

The volume at hand contains six papers and associated comments from a conference at the City University, London. I would like to report that the papers add up to a serious contribution, but I cannot. The contributions are seriously flawed. A common assumption is that financial crises can be understood without explicitly considering the financial structure and the cash flows (wages, profits, taxes and foreign exchange earnings) that support the payment commitments of the financial structure: essential capitalist relations are not modeled. Thus the money supply appears as a variable in these papers, but the commitments that are undertaken as money is created are ignored.

Anna Schwartz' paper "Real and Pseudo-financial Crises" quite predictably assumes that monetarism is valid. Her aim is to show that "The bugaboo of financial crisis has been created to divert attention from the true remedies that the present financial situation demands" (p. 13). Real and pseudo-financial crises are distinguished: real financial crisis occurred because "no institutional framework was immediately available to deal with the surge of demand for high-powered money by the public and the banks" (p. 18); therefore "there is a well-understood solution to the problem: assure that deposits can be converted at will into currency whatever the difficulties the banks encounter" (p. 28). It follows that none of the episodes of the past twenty years qualify as true or real financial crises.

One of the precepts of monetarism is that Smith's invisible hand proposition is valid. But in Schwartz' account recent potential crises were transformed into pseudo crises by the visible hands of central banks and deposit insurers: appropriate intervention is stability enhancing.

"The Avoidance of Catastrophe: Two Nineteenth-century Banking Crises" by Roy A. Batchelor, introduces formal models of catastrophe and reactions to uncertain information in an endeavor to throw light on two nineteenth century episodes: the collapse of Overend. Gurney & Co. Ltd. and the liquidation of Baring Bros. A catastrophe theory approach to manias or bubbles leads naturally to an analysis that emphasizes cash flows, liability structures and the role of externally financed demand in determining income and employment. The ability to validate business debt by floating new debt has to be contrasted with the validation of debt by profit flows. Batchelor has a catastrophe occur when units systemically have to sell assets to obtain cash, but why this occurs only sometimes is not made clear. The question about why Gurneys was sunk and Barings was rescued is answered by noting that it was the "difference in political and personal relations between these institutions and the officials of the Bank of England which determined who should sink and who should swim" (p. 71). This conclusion does not rest upon the formal mathematical argument.

Teresa Seaborne's "The Summer of 1914," and Forest Capie. Terence Mills and Geoffrey Word's, "What Happened in 1931" examine two crises. The war crisis of 1914 was clearly not part of a normal business cycle. Cash flows were disrupted by hostilities and quite rationally the outbreak of the war made liquidity more valuable. The international flow of loans from Britain to roll over debtors was halted; as a result loans could not be repaid.

The suspension of specie payments, providing for subsidiary currency and measures to make institutions which were not receiving funds from enemy debtors "whole" enough to function resolved the crisis. The way it was resolved is not linked to later developments such as deposit insurance.

In 1931 Britain left the gold standard. Capie, Mills and Wood conclude that in 1931 "the world saw the consequences of central bankers not understanding central banking " (p. 144). I would go a bit further. Before central bankers can understand central banking they need to understand the economy. Behind the absence of successful intervention in the 1930s lay a lack of understanding of the relation between government intervention to sustain profit flows and central bank intervention to contain asset price declines and shortages of liquidity. The same lack of understanding of the links between income production and the financial structure is still prevalent.

Hugh Rockoff's "Walter Bagehot and the Theory of Central Banking" is a model exercise in the history of thought. Bagehot is remembered for the prescription for central bank behavior in times of crisis "lend freely at high interest rates" (p. 160), but he also argued that it is necessary for a central bank to "protect the reserve when the market is merely apprehensive" (p. 161).

Rockoff makes it clear that a central bank has to be ready to "shift gears." It is the task of monetary theorists to instruct central bankers so that they know when to shift. This means that theory must identify indicators of the crisis–proneness of an economy. Neither Rockoff nor any of the other contributers tell us how this identification is to be made.

In "Financial Crises, Banking Crises, Stock Market Crashes and the Money Supply: Some Evidence 1870–1933," Michael D. Bordo identifies two main approaches to understanding financial crisis. The monetarist approach of Friedman, Schwartz and Cagan and an alternative real cycle approach identified with Fischer-Minsky-Kindleberger. The latter

> regards financial crisis as an essential part of the upper turning point of the business cycle—as a necessary consequence of the previous boom. The modern proponents. Minsky and Kindleberger, basically extend the views Irving Fisher expressed in *Booms and Depressions* (1932). (p. 197)

Certainly Minsky, and I believe Kindleberger, would argue that they are integrating insights from Fisher and from Keynes' *General Theory*. In my understanding the Minsky-Kindleberger theory combines an investment theory of business cycles, a financial theory of investments, and the explicit modeling of financial structures as payment commitments. Wages, profits, rents, taxes and the foreign balance are the sources of funds to fulfill these commitments, and these "sources" in turn depend upon the extent of new debt or other external financing. It follows that comparing the explanatory performance of a Friedman-Schwartz and a Kindleberger-Minsky model by analyzing purely monetary relations is inept: the two models require quite different data bases for testing.

To conclude, the papers are interesting for the topics they raise rather than for their analytical frameworks or their concludions.

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Futures markets: Their economic role. Edited by ANNE E. PECK. AEI Studies in Government Regulation. Washington, DC: American Enterprise Institute for Public Policy Research, 1985. Pp. xiii, 325, $21.95. ISBN 0–8447–3592–2. *JEL 86–0754*

Futures markets: Regulatory issues. Edited by ANNE E. PECK. AEI Studies in Government Regulation. Washington, DC: American Enterprise Institute for Public Policy Research, 1985. Pp. xiii, 376. $24.95. ISBN 0–8447–3593–0. *JEL 86–0753*

Since their start more than one hundred years ago, organized futures markets have frequently been misunderstood and denigrated. For example, in the 1890s they came within a hairsbreadth of being outlawed. They alone must justify beforehand that a new instrument benefits the economy rather than relying on the actual desire for trading to prove their case. This scrutiny extends to the Federal regulatory agency, the Commodity Futures Trading Commission, that oversees futures markets. Part of the legislation renewing the CFTC in 1982 authorized studies on the purpose of futures markets, especially the emerging financial futures, and their interaction with existing securities markets. These two volumes, with essays by many of the leading scholars of futures and securities markets, are meant to complement the government's studies.

These companion volumes comprise thirteen self-contained essays. For the most part the essays review the literature, such as that on livestock futures. Written with the nonspecialist in mind, most emphasize verbal descriptions. There is a minimum of formal modeling or statistics.

Among the reviews of the literature, the ones by Anne Peck on traditional agricultural futures markets and by William Silber on financial futures markets stand out. Peck's essay succinctly