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Is a Financial Crisis Likely or Avoidable?

Hyman P. Minsky Ph.D.

Is A Financial Crisis Likely or Avoidable?*

by
Hyman P. Minsky
Washington University
St. Louis, Missouri

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*The Title is due to Professor G. L. Bach.

1. The development of financial structures conducive to a financial crisis and the occurrance of "flash point events" for a crisis are endogenous to the operation of our type of economy (a capitalist economy with a complex, sophisticated and evolving financial structure, where innovations in financing practices occur). However the resolution of the crisis depends upon the structure of the economy and the extent of lender of last resort (concessionary refinancing) by the Federal Reserve and other institutions, both public and private. In particular the same processes that led to the "horror story of 1929-33" in an economy with a small government and an absence of effective lender of last resort interventions leads to the inflation with relatively slow growth and unsatisfactory unemployment rates in an economy where government is big and lender of last resort refinancing of threatened positions is both prompt and on a sufficient scale.

2. In the current (end of October) situation a "financial crisis" is quite likely to develop - in fact we have a continuing "crisis" in the ~~stiuation~~ sit ation of the thrifts - but the likelihood that this "crisis" will lead to a deep depression is slight if the pattern of massive government deficits and lender of last resort refinancing such as took place in 1966, 1970 and 1975 is replicated. (This combination of deficits and lender of last resort interventions also occurred in 1980). Thus policy actions and in particularly the always discretionary refinancing interventions by the Federal Reserve and other authorities are essential determinants of system behavior.

3. The propositions in the first paragraph are "theorems" within the "Financial Instability Hypothesis Interpretation of Keynes". This interpertation of Keynes, which is one strand of the so-called Post Keynesian view of how our economy functions, holds that the integration of Keynes and Walras to form the

neo-classical synthesis grossly misinterprets Keynes, for Keynes' theory thoroughly integrated financial practices into the determination of how the economy behaved, whereas the neo-classical synthesis ignores financing practices. Whereas the economics of the neo-classical synthesis - which underlies both orthodox Keynesianism and the pre-rational expectations versions of monetarism - is based upon a "village market" trading perspective of the economic process, the economics that Keynes developed was based upon a "City" or "Wall Street" perspective.

4. In a "City" or "Wall Street" perspective the primary "variables" are the cash flows to and from economic entities. A "Wall Street" perspective asks not what is being "produced" but what is "profitable". Each unit from this perspective is a "balance sheet", a set of current and prospective income statements and current and prospective financing requirements. As I emphasized in papers I prepared for the Board of Governors some 15 years ago, the liabilities of all balance sheets can be transformed into a time series of dated payment commitments along with commitments to pay cash upon demand or if specified contingencies occur. Income flows (such as gross profits), borrowing and selling of assets are the sources of the cash flows to a unit.

5. The relation between cash payment commitments and prospective cash receipts is a key analytical construct of the Financial Instability Hypothesis: balance sheet items are transformed into a dated and a conditional series of cash flows. These cash flow relations are classified as hedge, speculative (roll over) and Ponzi (capitalization of interest) financial structures depending upon whether (1) income flows to a unit are sufficient to fill all of the payment commitments (Hedge finance), (2) income flows to a unit satisfy the interest but not the repayment of principal part of payment commitments

(Speculative finance), or (3) income flows to a unit cannot cover all of interest payments (Ponzi finance).

6. If we take that the on the whole fulfillment of payment commitments is a prime requirement for normal functioning (stability etc.) of our type of economy, then the classifications of units as hedge, speculative and Ponzi finance units indicates where things may go wrong so that payment commitments are not fulfilled. Thus for a hedge unit to fail to meet commitments its income (wage for households, profits for business) must fall. For a speculative unit any "disappearance" of the unit or market in which debt is rolled over can lead to a failure to perform. A Ponzi unit is especially vulnerable to rising interest rates and a revaluation of far distant profit or price prospects, for the typical Ponzi unit is counting on a "bonanza" or a "profitable selling out of position" to fulfill its payment commitments. Ponzi units can borrow because there is a reasonable expectation that some future cash receipt will enable the unit to fulfill the increasing payment commitments.

7. In the theory it is shown that one result of profit seeking activity in a world characterized by uncertainty is that over a "run of good times", when only minor business cycles occur (such as 1922-29 and 1946-66), the financial structure of private units, as measured by cash flow relations, migrates from being heavily weighed by hedge finance to increasing ratios of speculative and Ponzi finance. This takes place because of the financing deals of business men, households and bankers. However the "habitat" of a unit can change because of market developments. Thus any sharp rise in interest rates can lead to a migration of units from hedge to speculative and from speculative to Ponzi finance. Rising interest rates will increase the gross payment commitments and principal and interest quite quickly relative to the basic income cash flows that support the debt structure.

8. Of course changes in income prospects will also change the "habitat" of units. Thus a decline in income receipts - especially in gross capital income - will tend to make units migrate from the hedge end of the financing spectrum to the Ponzi end. Similarily, if as has been true over the recent past and is still true, the long term bond market is shut down then financing programs that would have used long term debt to keep a unit towards the hedge end of the financing specturm will have to be abandoned and units will be forced to migrate towards the speculative end of the financing spectrum because of the short term of the debt they can issue.

9. The analysis of cash flows relations applies not only to business but also to households and financial institutions. The very migration from hedge to speculative financial postures that takes place during good times in business firms also takes place for households and financial institutions. Furthermore interest rates and income changes have similar "forced migration" aspects for these other sets of economic units.

10. In various writings I characterized the voluntary and then the system induced migrations as a shift from robust to fragile financial structures. The shift from fragile to robust financial structure for the private sectors of the economy have occurred in two ways: (1) the wholesale bankruptcies and debt defaults that characterized the great depressions and (2) a period in which private sectors run surpluses because government runs deficits. At the beginning of both "post war periods" - 1919 and 1946 - the government debt component of the financial structure was very large. This made the balance sheet commitment/income relations of private units very robust. A similar movement from fragility to robustness occurs when bankruptcies occur, but such

positive effects of bankruptucy can be offset, as it was in the 1930's, by an extremely large fall in income, profits and prices. (By many measures the burden of private debt was larger in 1935 than in 1929).

11. A critical variable in the financial instability hypothesis is the flow of funds to business that serves to validate business debt i.e., the gross capital income of business. (I will henceforth call this gross profits). To close the analysis of financing relations it is necessary to make profits an endogenous variable that depends upon system performance. Fortunately in the work of Kalecki (it is also in Keynes) there is a theory of profit determination under capitalist conditions which relates profits to investment, the goverment deficit, the foreign trade balance and the savings propensities of recipients of wages and profis. This Kalecki/Keynes view of profits shows that a fall in investment will lead to a fall in profits unless other profit inducing factors change to offset this effect of investment.

12. Profits are the critical element in determining the willingness of firms to hire workers and in the decisions of business men to invest. Investment takes place because of prospective profits and investment is financing because the prospective cash flows from utilizing the investment good exceed by a goodly margin the cash flow commitments that have to be undertaken to acquire the financing for investment. Keynes' theory is really the basis for an investment theory of the business cycle and a financial theory of investment, in which prospective future profits both "lure" the business man to make his investment and "entice" bankers to accept commitments to make payment in the future in exchange for financing investment activity. Any systemic failure to honor past commitments to make payments will make bankers "reluctant" to accept newly created commitments. In the language of the orthodox Keynesians such changes

in the acceptable liability structure for financing investment is a shift in liquidity preference.

13. The external financing of business that gives rise to the liability structure normally takes place because investment and positions in capital assets need to be financed. When the voluntary and system induced migration of business, households and financial institutions towards the Ponzi end of the financing spectrum takes place the possibility increases that units will have difficulty in financing the roll over of their debt or an increase in their debt to pay interest because the agents which would provide for the hoped for financing doubt whether the funds being sought will be repaid. The ability of units to validate liabilities becomes increasingly questionable as they engage in increasing rates of Ponzi and roll over financing. When this doubt becomes significant, and doubt may be triggered by a not unusual event, then the financing of investment will be more difficult and investment will fall. But a decline in investment will lower profits so that the cash flows upon which the debt structure that is based upon private business debt rests will fall so that debt becomes an "increasing" burden.

14. In a capitalist economy stabilization policy can only be successful as it stabilizes profits. An expansionary policy is successful as it first stabilizes increases and then holds out prospects of increasing profits. The main difference between the economy of the 1920's and that of the 1980's is in the size of government. If government is so big that swings in the deficit can offset swings in investment then no depression of the order of magnitude of 1929-33 can occur.

15. Therefore there are two "policy" parameters that determine whether a debt deflation can occur: these are the propensity of government to run a profit sustaining deficit and the willingness and ability of the Federal Reserve

(in cooperation with other agencies) to engage in concessionary refiancing i.e., to act as a lender of last resort. Beginning on page 15 of Finance and Profits: the Pitfalls of Stabilization Policy in Our Economy which I hope everyone received, there is an analysis of the possible effects of the various mixes of government deficits and lender of last resort interventions that can be the reaction of the authorities to an initial or even a sequence of credit crunches.

16. I want to return to the title assigned to my remarks by Prof. Bach. A financial crisis is not a well defined concept without an analytical structure in which events that can be labeled a financial crisis can occur. It is not useful to discuss financial crises within the framework of orthodox Walrasian economics, whether the macroeconomics are monetarist or income employment Keynesian, for financial crises are non-events within these theories. Within the analytical framework of the financial instability hypothesis a financial crisis occurs when, in a financial structure heavily weighted by speculative and Ponzi finance units and markets in which units need to roll over debt or capitalize interest, units find that they cannot do so on market determined terms i.e., because of systemic characteristics a set of units emerges which require concessionary refinancing. If such conesssionary refinancing is forthcoming from the Federal Reserve, other government agencies or giant private financial organizations then a lender of last resort intervention has taken place.

17. If the Federal Reserve is to do a better job it must base its operations on an explicit frame of analysis within which the structural characteristics of fianancial interrelations, as well as the performance of the economy in generating incomes, determines the susceptibility of the economy to financial crises. Such a frame of analysis should also indicate what the consequences of

interventions by the Federal Reserve to refinance threatened sectors and institutions on concessionary terms will be.

18. Among the considerations that brought the Federal Reserve into being was the felt need for a lender of last resort. Within the financial instability hypothesis the behavior of the Federal Reserve, when it has to act as a lender of last resort, really can affect the path of the economy. Policy is not ineffective in a world with a complex financial system.

19. Now to answer Professor Bach's questions. A financial crisis is likely -in fact we have had a series of pre-emptive lender of last resort interventions in the recent past. There is no way to avoid financial crises as long as capitalist financial practices, with the ability of units to innovate financial practices, are ~~is~~ sustained. However the unavoidability of financial crises within a framework of capitalist finance and possibly of financial innovations does not mean that an interactive debt deflation such as occurred in 1929/33 is inevitable. Prompt lender of last res~~p~~ort intervention can prevent a debt deflation, if it is wedded to a large enough government deficit. However, it is quite likely that the inflationary turbulence we have experienced in the past decade is a consequence of the process by which deep depressions, due to an interactive debt deflation, have been avoided. This experience of the past decade, in which we bought a good thing - no deep and long lasting depression - with a bad thing - chronic and accelerating inflation along with stepwise increasing unemployment - is just another example of the universal propostion that "there is no such thing as a free lunch!"