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The Financial Instability Hypothesis: An Alternative View

Thanks to the discussion¹ triggered by Professor Milton Friedman's two articles², in which he finally put forth an explicit model that embodied his views, it is now evident that the monetarist - income expenditure controversy was, and remains, a controversy within a school - in this case the school's label is the neo-classical synthesis - rather than among schools. The differences between the views of a Tobin, Patinkin, Brunner-Meltzer and Friedman are much more in the nature of quibbles than in differences about fundamentals; their views about the basic behavioral attributes of the economy are fundamentally identical.

Davidson, in that symposium, did proffer an alternative view - which was "put down" by Friedman by recourse to handwaving and a temper tantrum that I suppose was intended to pass as wit. Friedman at no point met the serious issues raised by Davidson. For example Friedman writes:

Friedman: Comments on the Critics

V.P.E. Sept/Oct 72 p. 923

"The four chapters (12, 17, 20 and 21) Davidson refers to contain many correct, interesting, and valuable ideas, although also some wrong ones, and many shrewd observations are empirical matters, particularly the operations of financial market. But all four chapters are strictly to the main contribution of the General Theory." [J.P.E. p. 923]

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Chapter 12 in The General Theory is titled "The State of Long
Term Expectations" and it is this chapter that Keynes discusses
uncertainty. He not only refers back to his Treatise on
Probability [GT pl48] but, in the major post-general theory
exegesis of his view of his contribution - the rebuttal to Viner's
review in the Q.J.E. - he emphasizes the significance of
uncertainty.³⁸ he understands it in the determination of system
behavior. In Chapter 17 the fundamental rationale for liquidity
preference - which is that in a world of uncertainty money - and
other assets which in the terminology used a few years ago
have broad deep and resilient markets - yield a return in kind
(labeled I in the General Theory) is set out. My view - and I
believe this view is fully borne out by the content of the much
neglected rebuttal by Keynes to Viner - is that no interpretation
of The General Theory which treats chapters 12, 17 and 22 (Notes
on the Trade Cycle) as peripheral and as "gossip" is true to
Keynes. I also happen to believe that such an interpretation
leads to a view of capitalism that is both more valid and useful
than the views of the neo-classical synthesis whether in the
monetarist or the income-expenditure garb.

Friedman cavalierly dismisses Davidson's call for a serious
consideration of uncertainty by remarking that in his, Friedman's,
analysis "Uncertainty may not be explicitly mentioned, but it
certainly is taken for granted throughout the analysis." p923.

But what is singularly at issue is what is meant by uncertainty - and Keynes in his rebuttal to Viner was most clear in differentiating his views from those who in modern terminology assume a stochastic disturbance with zero mean and finite variance as being added into an otherwise analytically defined relation.

Although I cannot claim to have mastered the as usual difficult paper by Brunner-Meltzer in that same Sept/Oct 72 issue, I welcome their acceptance of the fundamental Keynesian proposition that

"The dominant wealth effect induced by monetary (and some fiscal) policies is a change in the price of existing assets relative to the price of new production (the price level)" [JPE p952]. This of course is no more than the view explicitly put forth by Keynes in his rebuttal to Viner. Keynes' liquidity preference function sets the price of a representative unit of capital assets as a function of the money supply relative to the supply curve of capital assets. The key argument is that the liquidity preference function is unstable - it shifts - whereas the supply curve of investment goods is a function of the slowly moving price of labor. The sluggish movement of prices and usages is due to frictions currently identified with search and information costs. The 'unemployment' of Keynesian analysis is above and beyond this frictional unemployment.

An aside and then into the substance of the financial instability hypothesis: the Keynesian view is not that wages and prices are rigid: they are sluggish in reacting to transitory

excesses and deficits in markets but they do react, and persistent excesses and surpluses will be fully reflected in price and wage movements. ^{The} Keynesian view is that if there is real aggregate excess supply (or demand), price and wage level change are not efficient processes in removing the excess. That is the market mechanism is assumed in standard theory to operate so that persistent excess - or deficit - of demand in a market set off an own market process that is efficient and thus removes the excess or deficit. Keynes is skeptical that his view of how markets operate is relevant for the labor market ; counterexamples are developed which are sufficient to upset the full generality of this view. The significance of Keynes' ~~Esse~~ and real balance effects is that they introduce an indirect (i.e. other market) reaction which transforms an otherwise inefficient process into an efficient process.

The Financial Instability hypothesis states that the financial system of a complex sophisticated capitalist economy is essentially unstable and that this instability is the dominant factor in generality fluctuations in investment, and thus in generality business cycles. System behavior is compounded out of the interactions of financial and real influences; a decision to invest is always, in such an economy, a decision to emit liabilities.

A theorem of this view is that business cycles are inevitable in a capitalist economy: a slogan which may explain this view is that "stability is destabilizing".

There are two aspects to financial instability: (1) financial innovations in response to profit opportunities; and (2) variations in financial ratios even within stable financial institutions, in response to the financing requirement of shifting leading reactors.

In order to set forth the financial instability hypothesis it is best to take another look at the concept of "money" in an economy with fractional reserve banking. To a banker his demand deposits are an instrument by which he finances his position in economy assets, just as the mortgage on my home is the instrument by which my position ~~in my home~~ is financed. Money therefore is a special type of liability: its special nature is due to the existence of units (borrowers) which are committed to operate so as to acquire money in order to meet their contractual commitment to their lenders - the banks.

During the conglomerate movement of the 1960's, the idea spread that "funny monies" were being used in these takeovers: These funny monies being combinations of instruments used in acquisitions. Once again just as for banks and demand deficits, these funny monies were liabilities that were used to finance position in assets.

In fact in a capitalist economy any unit can issue money, the only question is to get it accepted. The acceptability of any instrument to finance positions in assets varies over time.

The essential way in which uncertainty enters into the operation of a capitalist economy is as a determinant of the liability - structure that is acceptable in the financing of positions in assets. Fundamentally, a liability is a contractual commitment to pay cash, either along a given time schedule, on demand, or if a specified contingency occurs. Fundamentally a set of capital assets collected in a firm is expected to yield a set of quasi - rents - or cash flows - along some time schedule. What the liability structure does is commit cash flows.