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STYLIZED LESSONS FROM THE EIGHTIES

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"...SHADY LADIES FROM THE EIGHTIES WHO ARE INDISCRETE",

lyrics of 42'nd street
Outline

I. meaning of stylized facts, stylized lessons are experiences that changes the stylized facts and therefore changes the degree of belief that a rational agent would have in theories that are based on these prior facts. The question we need always ask is "What is there about recent experience that changes our belief in prior theory?" The test of theory is always in what will reject the theory

II shady ladies

III The most important event of the post world war 2 era is something that has not happened. There has not been a big depression.

IV There are two sets of Business Cycle theories:
1. Big depressions are due to idiosyncratic events, to shocks to an inherently stable system
2. Big depressions are due to some inherent characteristics of capitalist economies?
The first set of theories lead to propositions that if the institutional structure is apt then market forces can be relied upon to generate desirable outcomes. The second set of theories come to the conclusion that apt constraints and interventions are needed if a market system is to yield apt results.
Theory 1. The system of markets of a capitalist economy inherently generates relatively smooth growth. However disturbances due to shocks, which arise in one or more of the monetary mechanism, the behavior of wages, malefactors of great wealth, tariffs, etc. are averaged by the behavior of markets to generate the cycles of experience. This is the cycle theory of Marshall, Frisch, Slutsky, Friedman, and Lucas.

Theory 2. The system of markets of a capital using capitalist economy are inherently unstable: they are best modeled as a non linear time dependent structure which endogenously generate time paths that can be characterized as chaotic or incoherent. Cycles are viewed as an inherent characteristic of a capitalist economy with the monetary and financial structure that characterizes such economies. This is the cycle theory of Marx, Mitchell, Schumpeter, Keynes, and Kindleberger. It is also an essential proposition of the American Post-Keynesian views.

V Deposit insurance

VI Big government and central bank interventions but essential role of treasury

VII Success in avoiding a big depression delegitimitizes the big government that makes for the success
VII The nice polite equilibrium seeking and sustaining view of that economic theory holds to be true is not really true. The implications of non-linear dynamical systems as the appropriate model of the economy.

IX The emergence of money manager capitalism.

X. Two theorems:

A. anti laissez faire

B. nothing works forever.

XI The ultimate Cassandra question: "What does it take for the United States to become another Argentina?"
Lord Kaldor often referred to "stylized facts": These "facts" are broad statements of some main characteristics of an economy that economic theory has to explain. Stylized facts abstract from muddy bothersome details. Not everyone would agree upon a list of significant stylized facts and their precise wording. This ambiguity pleased Nicky for this gave him degrees of freedom in argumentation which he relished, and took advantage of. He could adjust the substance of the stylized facts to advance whatever particular horse he was riding at any time.

We know that theory is constructed by asking "What premises do I need in order to derive a specified conclusion?". I believe it was Adlai Stevenson who quipped that "These are the conclusions form which I draw my premises" but the quip was not trivial: he was stating that in serious science observations determine the task of theory. What theory has to explain and therefore theory itself changes when observations that deviate from what has been known in the past are made.

If developments in the world are at odds with what happened in the past so that there are lessons to be assimilated then the analytical framework may require adjustment. The perennial scientific question is what do we have to observe in order to change the theory we sustain.
The aim of scientific thinking is to determine premises which enable us to derive what is known as theorems: premises which are rich in that other than the observations that conditioned the premises can be derived.

Stylized lessons are analogous to stylized facts. They are observations, events and developments in understanding that are at variance with the "facts" that are the conclusions which the inherited analytical structure supports. The contention is that the eighties were rich in observations that are lessons in the sense that they require a revision of the theorems that economic analysis supports.
The title "Stylized lessons from the eighties" echoes the line from the song 42nd Street: "...shady ladies from the eighties who are indiscreet". The eighties ended with a well populated rouges gallery of corrupt and devious practitioneers in finance, industry, trade and government. For example the use of payment in kind instruments in deals and the acceptance of such instruments into portfolios of managed other people's money or in portfolios where a government guarantee replaces the manager's equity in providing the margin of safety meant that in the eighties "Ponzi was alive and well" in our financial structure. and shady ladies were not rare became common.

One lesson from the eighties is that protracted success is corrupting: it erodes scepticism. We all wear blinders which restrict our fields of vision, our priors lead us to ignore embarassing evidence, but over periods in which our priors are not challenged our priors become ever tighter, the fields of vision, the alternatives that are contemplated, become ever more restricted. The quality of financial and other forward looking decisions, such as investment, where the priors are inputs to the formation of expectations, deteriorate because they lose touch with the world as it is. Over a run during which the economy is successful the subjective view of what the world is like and the objective circumstances may well grow apart.
The first stylized lesson is that success of the economy is likely to reenforce an inherited model of the model, even as structural changes erodes the domain of validity of the inherited model.
The most important fact about the era since World War II is that a big depression has not happened. In this the 1980's were a continuation of the 1950's, 60's and 70's. However the 1980's were not a mere extension of the prior three decades for during this decade a big depression did not happen even though the financial disruptions - the financial crises - were more frequent and greater than in the earlier decades of the post World War 2 decades.

The 1980's can be characterized as a decade in which financial crises occurred regularly and were "contained" by central banking and Treasury interventions, and the manner in which the cash flow impact of big government sustained cash flow. In the asset price index now had a substantial decline. The essential domestic financial institutions and the legal structure of the United States in the post World War 2 epoch was put in place during the great depression. They largely reflected the theoretical understanding of that time of how finance worked. One aspect of the philosophy of the New Deal was that "malefactors of great wealth" were responsible for the great depression. This view, that there was nothing essentially wrong with the capitalist economy, was the dominant view that guided the reforms of the 1930's. The view was that some constraints and controls upon those who controlled the wealth of the economy and managed financial institutions was needed: deposit insurance involved a trading material submission to examined firm and manage constraint. This malefactors of great wealth view led to the neglect of the features of the General Theory that
emphasized that the capitalist way of valuing assets and determining investments made financial disturbances and debt deflations inherent in the process: i.e. that there was an flaw in capitalist economies which could be contained at least for a while if policy was wise in that it reflected a theory which acknowledged that the flaw existed.
One aspect of the 1930's reforms was the institution of deposit insurance. Deposit insurance was introduced because the Federal Reserve had failed to prevent the great debt deflation of 1929-33 and it was felt that a government endorsement of deposits would undo the currency and precious metal hoarding that had grown up in response to the losses on financial assets. Deposit insurance was not a free ride to the insured institutions. Restrictions on assets as well as examination by national authorities was part of the price of being insured.

Deposit insurance was not tested until the last few years. During the years before the 1980's deposit insurance had only been invoked in rare cases where either gross incompetence or fraud "broke" an institution. The financial institution failures that called for deposit insurance interventions could have been handled by bonding.

characterized by contained crises and rolling adjustments.

The eighties are but a part of the post World War II experience. Two theorems can sum up the post war period:
One I call:

the Anti Laissez faire theorem:

the other is

the transitory nature of success theorem.
Anti Laissez Faire theorem: Apt policy is necessary for success in stabilizing the economy. In particular the objective of stabilization policy is profits or cash flows and big government and active flexible central banking is necessary. Question of what is apt and is apt invariant through time I took some of the issues of institutional evolution up in Central Banking and Money Market Changes of some thirty years ago.

Policy regimes. Aptness of a policy regime if system behavior conforms to some pre determined standard. The aptness of a policy regime is attenuated as units learn the cost of the policy regime to them and act to minimize these costs. The adjustment of agents behavior that results makes the inhereted policy regime inept.

In the S&L crisis, when push came to shove, we find the treasury picking up the losses rather than depositers. Federal reserve refinancing was insufficient for the crisis was not so much liquidity as it was insolvency.

It is important to keep the debt of the government "valuable" which means that the tax revenues would allow for the debt to be reduced when the economy is functioning normally.
The validity of the endogenous instability view;

the interpretation of the present status of economic theory as accepting that the existence of a competitive equilibrium that is Pareto optimal has been demonstrated but the neoclassical set up does not lead to the demonstration of the uniqueness of the competitive equilibrium nor its stability.
The perrenial question of economics is whether m c m or c-m-c leads to a more productive use of the propensity to theorize.

The transition among capitalisms. The emergence of money manager capitalism.
Economist were to become like dentists in the arrogant view of Keynes. Evolution and the fact that market economies determine and change their institutions means that policy oriented economic statements are conditional upon institutions and usages and these change endogenously.