The Man Behind Understanding Crises: Hyman Minsky and the Financial Instability Hypothesis

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When the subprime mortgage crisis of 2008 was dubbed a *Minsky Moment* by John Cassidy of the *New York Times* only then did Hyman Minsky garner attention. Hyman Minsky, an American economist who belongs to the Post-Keynesian school of economic thought along with Joan Robinson, Nicholas Kaldor, and Piero Sraffa. His ideas are still considered heterodox in a majority of economic discussions regarding financial crises.

The underlying proposition of his work was that an economy and to some extent capitalism, are unstable, easily ricocheting into a boom and bust cycle over short periods. Minsky was influenced by his doctoral advisor, Joseph Schumpeter, who also discussed the inherent instability of capitalism in his seminal work, *Capitalism, Socialism and Democracy* published in 1942.

The Financial Instability Hypothesis

Minsky's financial instability hypothesis has both, *empirical and theoretical aspects*. The empirical aspect of the hypothesis pertains to the observed trend in the Gross Domestic Product (GDP) such as the business cycle. Theoretically, Minsky presents the idea that we exchange present money – which goes into paying for resources for production – with future money – the profits or perhaps new liabilities that will be acquired in time. In other words, a firm finances its activities with liabilities, relying on future money to repay its current liabilities. Minsky further introduces the debt characteristics of three specific units, hedge, speculative, and Ponzi finance units. Hedge units are those that can pay off any debt from current cash flows including profits. Larger the share of equity finance, the greater the chance that it is a hedge unit.

Speculative units are those that cannot pay their outstanding debt with current cash flows, instead, they must rollover their debt or liabilities. Rolling over is, as Minsky put it, *the issue [of] new debt to meet commitments on maturing debt*. Ponzi units are the riskiest of all three. These can neither pay the principal nor the interest on the debt and must thereby rely on fresh borrowing from a new entity or selling of assets in a desperate bid to repay today's debt, even if it means accumulating more liabilities.

He further proposed that, when the economy is beginning its ascent towards a boom, the aforementioned structure starts to change, transitioning from a hedge-dominated economy, which is relatively stable towards one to speculative and Ponzi units. The stability in the economy during a boom has an underside to it; hedge units begin to take more risks and accelerate their investment spending that may move out of sync with cash flows. Given their ability to roll over debt easily during this phase of the business cycle, hedge units begin morphing into speculative units. As the boom continues, over-leveraged speculative units unable to roll over debt turn into Ponzi units where fresh borrowing or sale of assets is the only recourse to paying-off matured debt. Meanwhile, older Ponzi units that have already over-borrowed must finally declare bankruptcy when all options for fresh borrowings close, leading to the popping of the asset bubble. This can be considered a general description of the subprime crisis that took place in the United States in 2008.

The two important conclusions arrived at by Minsky are; *the economy has financing regimes under which it is stable, and financing regimes in which it is unstable* and *the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system."*

Minsky's hypothesis is inextricably linked to endogenous money theory. Banks are not financial intermediaries which channelize savings into investment but are instead institutions that are endowed with the license to create money that allow them to expand their balance sheets as well as those units described above. When speculative units find it increasingly difficult to roll over bank credit it results in defaulting of loans, accumulation of non-performing assets by banks, and in some cases, bank insolvencies and closure. At the same time, these effects on banks can also lead to a fall in lending and a consequent decline in consumption and investment, taking the economy down into a recession or even depression.

Policy Responses to Financial Crises

Given that economic instability spins out of control extremely fast, the government must intervene to control these major fluctuations. On various occasions, Minsky recommended the use of fiscal policy, first as the lender of last resort essentially refers to the role of the government in bailing out late-stage speculative and Ponzi units which not only limit the failure or bankruptcy of these units but also controlling the quantum of non-performing assets that are generated and appear on the balance sheets of the financial institutions they have borrowed from. Second, through corporate taxation; direct corporate taxation, on the other hand, can effectively control the rate at which the boom accelerates, buying time for firms to come up with additional contingency measures in case the units decide to deleverage at an unprecedented rate. With the latter, however, there is always the issue of time lags, that is, the delay between when the policies are implemented and when they take effect. This can lead to situations in which the system in its normal course, self-adjusts and goes back to its pre-crisis growth rate. If the consequences of corporate taxes were to take effect at this point rather than when the problem existed, it can worsen the problem, rather than solving it.

Financial instability is not a recent phenomenon; ever since the eighteenth century when credit and banking began driving capitalism, crises have been a recurring occurrence. The Mississippi Company and the South Sea Bubble in the early decades of the eighteenth century are just two early cases-in-point. The ongoing Covid-19 pandemic has increased fiscal spending, enriching banks with reserve money so that they are willing to lend longer at lower rates. This could mean a growing number of speculative and Ponzi units, invisible for now, but fuelling a bubble that might implode post-pandemic. Is history doomed to repeat itself? Minsky's hypothesis not only provides clues to the causes of financial crises but also policy measures to tackle them.

Further readings:

Minsky, Hyman (1982), Can "It" Happen Again, Routledge, Oxon

Tankus, Nathan (2017), Endogenous Money, Explained Simply, https://www.youtube.com/watch?v=pJTHCn8U3Eg

Wray, Randall (2018), Endogenous Money, YouTube

Garber, Peter M. 1990. "Famous First Bubbles." Journal of Economic Perspectives, 4 (2): 35-54.