Minsky and the Flat Ocean Theorists

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UMKC & Binzagr Institute for Sustainable Prosperity
1 Digression on Unwinding the Fed’s Balance Sheet
If we consolidate the books of all the government agencies, then the Treasury debt held by the Federal Reserve Banks would appear as both an asset and a liability of the government. Such internal financial arrangements are usually ignored – the debt to all practical purposes does disappear once it enters the Federal Reserve System's portfolio.

HP Minsky

http://digitalcommons.bard.edu/cgi/viewcontent.cgi?article=1445&context=hm_archive
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gold certificate account</td>
<td>11,037</td>
</tr>
<tr>
<td>Special drawing rights certificate account</td>
<td>5,200</td>
</tr>
<tr>
<td>Coin</td>
<td>1,899</td>
</tr>
<tr>
<td>Securities, unamortized premiums and discounts, repurchase agreements, and loans</td>
<td>4,413,341</td>
</tr>
<tr>
<td>Securities held outright (1)</td>
<td>4,258,966</td>
</tr>
<tr>
<td><strong>U.S. Treasury securities</strong></td>
<td>2,464,546</td>
</tr>
<tr>
<td>Bills (2)</td>
<td>0</td>
</tr>
<tr>
<td>Notes and bonds, nominal (2)</td>
<td>2,339,280</td>
</tr>
<tr>
<td>Notes and bonds, inflation-indexed (2)</td>
<td>107,233</td>
</tr>
<tr>
<td>Inflation compensation (3)</td>
<td>18,034</td>
</tr>
<tr>
<td>Federal agency debt securities (2)</td>
<td>13,329</td>
</tr>
<tr>
<td><strong>Mortgage-backed securities (4)</strong></td>
<td>1,781,091</td>
</tr>
<tr>
<td>Unamortized premiums on securities held outright</td>
<td>169,292</td>
</tr>
<tr>
<td>Unamortized discounts on securities held outright</td>
<td>-14,941</td>
</tr>
<tr>
<td>Repurchase agreements (6)</td>
<td>0</td>
</tr>
<tr>
<td>Loans</td>
<td>24</td>
</tr>
<tr>
<td>Net portfolio holdings of Maiden Lane LLC (7)</td>
<td>1,708</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>90</td>
</tr>
<tr>
<td>Bank premises</td>
<td>2,198</td>
</tr>
<tr>
<td>Central bank liquidity swaps (8)</td>
<td>45</td>
</tr>
<tr>
<td>Foreign currency denominated assets (9)</td>
<td>20,115</td>
</tr>
<tr>
<td>Other assets (10)</td>
<td>28,860</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>4,484,492</td>
</tr>
</tbody>
</table>
5. Consolidated Statement of Condition of All Federal Reserve Banks (continued)

Millions of dollars

<table>
<thead>
<tr>
<th>Assets, liabilities, and capital</th>
<th>Eliminations</th>
<th>Wednesday from Apr 12, 2017</th>
<th>consolidation</th>
</tr>
</thead>
</table>

### Liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve notes, net of F.R. Bank holdings</td>
<td>$1,494,338</td>
</tr>
<tr>
<td>Reverse repurchase agreements (11)</td>
<td>$357,433</td>
</tr>
<tr>
<td>Deposits</td>
<td>$2,582,696</td>
</tr>
<tr>
<td>Term deposits held by depository institutions</td>
<td>$0</td>
</tr>
<tr>
<td>Other deposits held by depository institutions</td>
<td>$2,367,767</td>
</tr>
<tr>
<td>U.S. Treasury, General Account</td>
<td>$119,157</td>
</tr>
<tr>
<td>Foreign official</td>
<td>$5,174</td>
</tr>
<tr>
<td>Other (12)</td>
<td>$90,598</td>
</tr>
<tr>
<td>Deferred availability cash items</td>
<td>$651</td>
</tr>
<tr>
<td>Other liabilities and accrued dividends (13)</td>
<td>$8,783</td>
</tr>
</tbody>
</table>

Total liabilities                                                                 | $(0) 4,443,900|

### Capital accounts

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital paid in</td>
<td>$30,592</td>
</tr>
<tr>
<td>Surplus</td>
<td>$10,000</td>
</tr>
<tr>
<td>Other capital accounts</td>
<td>$0</td>
</tr>
</tbody>
</table>

Total capital                                                 | $40,592 |
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Back to the Originally-Planned Presentation
Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again.

JM Keynes
A Tract on Monetary Reform, p. 80
3

Key Query
• Real GDP = f (trend growth, shocks)
• Real GDP = \( f \) (trend growth, shocks)

• Inflation = \( f \) (expected inflation, GDP vs. Potential)
• Real GDP = f (trend growth, shocks)

• Inflation = f (expected inflation, GDP vs. Potential)

• Interest Rate Target = f (natural rate of interest, Taylor’s Rule, gradualism, forward guidance, etc.)
• Real GDP = f (trend growth, shocks)

• Inflation = f (expected inflation, GDP vs. Potential)

• Interest Rate Target = f (natural rate of interest, Taylor’s Rule, gradualism, forward guidance, etc.)

• Monetary Policy Dominance = f ("sound" fiscal policy)
Late 1980s—The First Soft Landing

Carolyn Clark, 1992, Ch. 9
Late 1980s—*The First Soft Landing*

![Graph showing Real Potential Gross Domestic Product and Real Gross Domestic Product from 1987 Q1 to 1992 Q1. The shaded area represents 1991 Q1.](myf.red/g/dgke)
Late 1980s—The First Soft Landing

Graph showing real potential gross domestic product, real gross domestic product, and effective federal funds rate.
Late 1990s—Soft Landing the New Economy

The graph illustrates the comparison between Real Potential Gross Domestic Product and Real Gross Domestic Product from 1999 Q1 to 2001 Q3. The data shows a steady increase in both metrics, with the potential product slightly lower than the actual gross domestic product. Sources include BEA, CBO, and the St. Louis Federal Reserve.
Late 1990s—Soft Landing the New Economy

Sources: BEA, Board of Governors, CBO
fred.stlouisfed.org
Late 2000s—Soft Landing the Great Moderation

[Graph showing real potential GDP and real GDP from 2004 Q1 to 2008 Q1]

Sources: BEA, CBO
fred.stlouisfed.org
Late 2000s—**Soft Landing the Great Moderation**
“Taylor-type rules have been out of fashion. While the policy rate’s at zero, they’re kind of useless.

But now that we’re talking about normalization, it’s interesting to look at the policy prescriptions of Taylor-type policy rules.

The particular rule that’s … been around policy circles for the last decade or more . . . suggests that we should have already lifted off.”
Late 2010s—Soft Landing the Age of Diminished Expectations
Late 2010s—
Soft Landing the Age of Diminished Expectations

[Graph showing economic indicators from 2014 Q1 to 2016 Q3]

Sources: BEA, Board of Governors, CBO
fred.stlouisfed.org
The FOMC policy rate projections vs. reality

The U.S. Macroeconomic Outlook

James Bullard
President and CEO, FRB-St. Louis

Australian Centre for Financial Studies
International Distinguished Lecture
April 10, 2017
Melbourne, Australia
The policy rate path dichotomy

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Conclusion

- The U.S. economy has arguably converged to a low-real-GDP-growth, low-safe-real-interest-rate regime.
- Because of this, the Fed’s policy rate can remain relatively low while still keeping inflation and unemployment near goal values.

The U.S. Macroeconomic Outlook

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What Would Minsky Do?
Not only is stability an unattainable goal; whenever something approaching stability is achieved, destabilizing processes are set off.
A capitalist economy can be described by a set of interrelated balance sheets and income statements.
<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabs/Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Payables</td>
</tr>
<tr>
<td>Receivables</td>
<td>Non-Debt Liabilities</td>
</tr>
<tr>
<td>Inventories</td>
<td>Short-Term Borrowing</td>
</tr>
<tr>
<td>Financial Investments</td>
<td>Long-Term Borrowing</td>
</tr>
<tr>
<td>Fixed Capital</td>
<td>Preferred Stock</td>
</tr>
<tr>
<td></td>
<td>Common Stock</td>
</tr>
<tr>
<td></td>
<td>Retained Earnings</td>
</tr>
</tbody>
</table>

Non-Financial Corporation
- Assets
  - Cash
  - Receivables
  - Inventories
  - Financial Investments
  - Fixed Capital

- Liabs/Equity
  - Payables
  - Non-Debt Liabilities
    - Short-Term Borrowing
    - Long-Term Borrowing
    - Preferred Stock
    - Common Stock
    - Retained Earnings

- Valuation
- Project Evaluation

- Non-Financial Corporation
- Minsky
Components of Domestic Private Sector Financial Balance as a % of GDP
1952q1 to 2016q4

Household
Non-Financial Business
Household Debt Service Payments as a Percent of Disposable Personal Income (left)

Effective Federal Funds Rate (right)

Sources: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org
Components of Domestic Private Sector Financial Balance as a % of GDP
1952q1 to 2016q4

- Household
- Non-Financial Business
- Financial
During a protracted expansion dominated by household and business deficits the ratio of household and business financial commitments to income rises, whereas in an expansion dominated by government deficits the ratio of private commitments to income decreases.

HP Minsky 1963, p. 412
We thus have the fundamental point of difference between the two approaches:

Is monetary policy (the Big Bank) to be assigned to control goods prices (monetarist) or aid fiscal policy to control quantities (neoclassical Keynesian);

or should it . . . be directed to stabilize capital asset prices [and the stability of the financial system in general]?

JA Kregel
1992, p. 88
Conclusion: The Return of Flat Ocean Theory? (Did It Ever Actually Leave?)
The Monetary Policy Committee of the Bank of England ... contained ... a strong representation of academic economists and other professional economists with serious technical training and backgrounds. This turned out to be a severe handicap when the central bank had to ... change from being an inflation-targeting central bank under conditions of orderly financial markets to a financial stability-oriented central bank under conditions of widespread market illiquidity and funding illiquidity.

Willem Buiter, 2009
• "Natural" or "Neutral" Rate of Interest?

• "New" View of Fiscal Policy?

• Evolution of Private Sector Financial Positions in FOMC Minutes or BoG/FRB Speeches? Threats from Rising Interest Rates?

• Discussion of Underwriting Quality and Margins of Safety? Related Financial Innovations, and Appropriate Regulatory/Supervisory Responses?
Soft Landing?
Or
Something Else Entirely?