

Contact: Mark Primoff
845-758-7749
primoff@bard.edu

FOR IMMEDIATE RELEASE

2007 U.S. CREDIT CRUNCH CAN BE SEEN AS “MINSKY MOMENT”

New Study Explores Recent Credit Crunch from the Perspective of the Late Financial Economist and Levy Institute Scholar Hyman P. Minsky

ANNANDALE-ON-HUDSON, N.Y.—As global financial markets and banking institutions continue to reckon with the economic implications of this summer’s credit crunch, a new study from The Levy Economics Institute of Bard College contends that the situation can aptly be described as a “Minsky moment.” In his public policy brief *The U.S. Credit Crunch of 2007: A Minsky Moment*, Charles J. Whalen explores recent financial events from the perspective of the late financial economist and Levy Institute scholar Hyman P. Minsky. Borrowing from George Magnus, senior economic advisor at UBS, Whalen describes a Minsky moment as the moment when—following a prolonged period of rapid acceleration of debt in which more traditional and benign borrowing is replaced by borrowing that depends on new debt to repay existing loans—lenders become increasingly cautious or restrictive, and even solid investment structures encounter financing difficulties. Whalen contends that Minsky’s financial instability hypothesis (FIH), which argues that the financial structure of a capitalist economy becomes more and more fragile over a period of prosperity, challenges the wisdom of the conventional belief in the inherent efficiency of markets and offers important insights into avoiding future financial breakdowns.

Whalen writes that, according to Minsky, during an expansion the economy (or a sector of the economy) evolves from what he called “hedge” finance to “speculative” finance, and then in the direction of “Ponzi” finance. In the so-called *hedge* case (which has nothing to do with hedge funds), borrowers are able to pay back interest and principal when a loan comes due; in the *speculative* case, they can pay back only the interest, and therefore must roll over the financing; and in the case of *Ponzi* finance, companies must borrow even more to make interest payments on their existing liabilities. “Both the evolutionary tendency toward Ponzi finance and the financial sector’s drive to innovate are easily connected to the recent situation in the U.S. home loan industry, which has seen a rash of mortgage innovations and a thrust

-continued-

toward more fragile financing by households, lending institutions, and purchasers of mortgage-backed securities,” Whalen writes.

Whalen describes a Minsky-oriented account of the 2007 credit crunch as starting with the housing boom, which followed the burst of the “dot-com” bubble in 2000. The housing boom was fueled by low interest rates and the proliferation of exotic mortgages, such as interest-only loans and option adjustable rate mortgages (ARMs), which enticed new and increasingly less creditworthy home buyers into the market. New players such as unregulated mortgage brokers promoted option ARMS because they were highly profitable for banks, which in turn offered the brokers high commissions. Securitization of mortgages meant that bankers bundled dozens of mortgages together and sold the bundles to investment funds such as hedge funds, which in turn used these mortgage bundles as collateral for highly leveraged loans. More issues were created by the credit rating agencies, such as Standard & Poor’s, whose ratings proved to a poor indicator of the likelihood of default. The eventual result of these factors and others, Whalen says, is the credit crunch or Minsky moment, which hit in midsummer of 2007. At that point, borrowing and lending—and the hiring of additional workers—became more cautious across the board. “This new cautiousness was partly due to panic, but it was also partly due to recognition of the fact that precarious borrowing had woven its way into the entire system—indeed, into the global financial system—and nobody really knew exactly where the greatest dangers were,” writes Whalen.

To conclude, Whalen contends that a “Minsky meltdown,” in which declining asset values induce a recession, related to this summer’s credit crunch is unlikely given the steps the Federal Reserve has taken to cut rates and inject credit into the financial markets. However, effects are being felt on both Wall Street and Main Street, with reports that more than two million holders of so-called “subprime” mortgages—loans given to people with poor credit—could lose their homes to foreclosure. The housing difficulties at the root of much of the credit crunch are likely to continue for some time. Since there is already a glut of homes on the market, the construction industry will most likely remain in a severe slump, and home prices can be expected to continue to fall. Given these results, Whalen maintains that Minsky would have advised that policymakers act to preempt future financial-market excesses by means of more rigorous bank supervision and tighter regulation of financial institutions. “Pulling out Minsky’s ideas only during a crisis, then letting them fall back into obscurity when the crisis fades, does a disservice to his contributions, which continue to speak to us in meaningful ways about the financial system and economic dynamics,” Whalen writes. “His scholarship challenges a belief in the inherent efficiency of markets. As a consequence, it also challenges a laissez-faire stance toward economic policy. His ideas draw attention to the value of evolutionary and institutionally focused thinking about the economy.”

###

Public Policy Brief No. 92: *The U.S. Credit Crunch of 2007: A Minsky Moment*

(10.19.07)