Minsky Moments

and

Minsky's Proposals for Regulation of an Unstable Financial System

Minsky Moment

- Popular in explaining the origin of the Crisis
- Emphasised Ponzi Scheme nature of housing mortgage market
- Ignored by Mainstream economists
- Embraced by Market Participants and Analysts
- Market is inefficient
- Not self-equilibrating
- But Minsky's Regulatory Proposals have been largely ignored

Regulatory Proposals were the Basis of the Financial Instability Hypothesis

"The risk characteristics of banking and the tasks of bank regulators are different in a world in which instability is a present danger than in a world in which markets are stable. If bank regulators are to do a better job than in the past, it needs to be based upon an understanding of how our financial structure becomes susceptible to financial crisis."

Effective Regulatory Proposals Require a Theory in which Financial Instability is the Normal

“Standard economic theory leads to the proposition that markets are equilibrating. It is evident that disequilibrating forces exist in the essential financing practices of a capitalist economy. These disequilibrating forces center in the financial of positions in capital assets and investment in progress. In time, financial practices lead to an environment in which financial crises can occur.”

The “Fundamental” Question”

- “the fundamental question in economic theory is whether the development of such crisis-prone situations … are the result of correctable institutional flaws, or are due to policy errors.
- A quite common interpretation, … is that events like our current crisis are due to errors of economic policy management rather than inherent characteristics of the economy.
- This appears to be the same approach that is currently being applied to reform of the US financial system which was disturbed by an “unpredictable 100 year event.”

Financial Distress

- Financial distress occurs when an individual financial institution "cannot meet its obligations on its balance sheet liabilities."
- This may evolve into a "financial crisis" when "a very significant subset of the economy is in financial distress" due to "'a slight disturbance' in money flows creates such widespread financial distress that financial crisis is threatened" the economy will exhibit "financial instability".

Financial Laying (interconnectedness)

- At each stage in the evolution toward financial instability financial intermediaries become more reliant on other financial institutions such as banks to refinance their liabilities.
- "A key to the generation of financial crisis is whether the holders of marketable securities who have large scale debts outstanding can refinance or must liquidate their positions when they need cash."
- "The worst thing that could happen to the solvency of any financial institution is a forced sale of its assets in order to acquire cash.

Access to Lender of Last Resort Support

- However, in order to avoid a financial crisis, should commercial banks refuse indirect accommodation to money and capital market institutions **“such access will have to become direct.**
- There is no reason why approved government bond dealers and approved finance houses should not have access to the Federal Reserve System, **now, when no crisis threatens.** In addition to the Federal Reserve System, there are number of other federal agencies that either insure the liabilities of financial intermediaries, guarantee the assets held by financial intermediaries, or act as a "lender of last resort" to some class of financial intermediary.
- A number of these agencies center around the home mortgage market and the specialized home mortgage banks… money has to be available when needed.”

OPEN THE WINDOW PERMANENTLY

- Thus, Minsky's basic recommendation in 1960, half a decade before the credit crunch that nearly bankrupted government bond dealers in the first financial crisis of the post-war period, and some fifty years before the current crisis, was to extend access to the Fed's discount window to primary securities dealers and all other important financial intermediaries on a permanent basis.
- The Fed should abolish its various special facilities and open the discount window to all financial institutions.

Financial Information – Tracking Instability

- Together with the proposal for the expansion of the discount mechanism, Minsky proposed a method of bank examination that recognizes the importance of the time distribution of cash flow commitments and the ability of institutions to liquidate their cushion of safety assets on a timely basis.
- Such a **“Cash Flow-Oriented” bank examination process** is “designed to focus upon the actual (past) and potential (near-term future) position-making operations of a bank, so that the Federal Reserve authorities could be aware of actual or threatened financial fragility. The perspective [is] … of a dynamic, evolving set of financial institutions and relations.
- All too often, it seems as if the Federal Reserve authorities have been surprised by changes in financial practices.”

The Fed as Financial Stability Regulator

- The use of "monetary policy to restrict aggregate demand …will lead to an economizing of cash balances.
- In place of increased activity being financed in part by increases in the quantity of money, increased activity will be financed almost entirely by substituting debt assets of private units for money in portfolios (or the monetary system may sell government debt to private units and acquire private debt).
- At every level in the economy such substitutions imply that each unit is less well able to withstand an interruption in its cash receipts; a given interruption of cash flows, say on income account, will now lead to a larger amount of portfolio changes at all levels in the economy."
- In short, Fed policy to restrict expansion will encounter resistance in the form of financial innovation which will largely offset it and create a more unstable financial structure.

The Fed’s Directive

- The Federal Reserve's directive to operate to achieve short-term stability of the economy should be replaced by a directive to keep stability in the financial markets and provide money for growth.
- The day-to-day open market operations in the money market should be replaced by easier and wider access to the discount window at posted rates to iron out temporary market difficulties.
- Open market operations should be undertaken in order to effect permanent increases in the money supply.
- Seasonal adjustments in the money supply should be the result of discount rather than open market operations.“

The Fed's Policy Role

- As long as the types of issues the government emits can affect the operation of the economy, and as long as the Federal Reserve System engages in open market operations as a part of its control technique, it may be desirable to make the Federal Reserve System responsible for management of the government debt.
- This can be done by making the Federal Reserve System, the owner of the entire outstanding government debt and having the Federal Reserve System issue its own debt in order to absorb 'reserves.' The Federal Reserve would be managing the debt and engaging in open market operations when it issued its own debt."
- **"To summarize, given the complex changing financial structure, the Federal Reserve System's role as a regulator of the economy should diminish while the Federal Reserve System's role as a lender of last resort to the financial system should increase."**

Lender of Last Resort and Inflation

- "Successful lender of last resort operations can result in subsequent inflation, … because the debts that caused the trouble are now in another private portfolio, and if these private portfolios are to be made healthy, the underlying cash flows have to increase. And one way to increase these cash flows is to finance inflationary expansion.
- Inasmuch as the successful execution of the lender of last resort functions extends the domain of Federal Reserve guarantees to new markets and to new instruments, there is an inherent inflationary bias to these operations; by validating the past use of an instrument and implicit guarantee of its future value is extended.
- **Unless the regulatory apparatus is extended to control, constrain, and perhaps even forbid the financing practices that caused the need for lender of last resort activity, the success enjoyed by these interventions in preventing a deep depression will be transitory; with a lag, another situation requiring intervention will occur."**

Regulation and Inflation

- "The need for lender of last resort intervention follows from an explosive growth of speculative finance and the way in which speculative finance leads to a crisis prone situation. To avoid this, institutional reforms that constrain corporate external finance and the capabilities of banks and other financial institutions to support explosive situations may be needed."
- This is precisely the challenge of reregulation of the financial system that is currently being faced in the United States.

Is there an Inflation Risk from the Fed's Current Crisis Response?

- The major concern would seem to be the presumed increased liquidity that is represented by the very large increase in unborrowed reserves in the banking system.
- But there is only one way these reserve funds can become a source of validation of the floor on asset values: if banks decide to lend to support the acquisition of impaired assets.
- It is unclear how this would produce an increase in demand for the underlying collateral.
- Rather this would require increased consumer spending at precisely the time when households are retrenching to rebuild balance sheets and banks are restricting lending.

A Floor on Impaired Asset Prices

- Although the Fed has acted to provide a floor to certain asset prices through its various special lending facilities and moved aggressively to substitute its own liabilities, in the form of reserve deposits for impaired speculative assets there are a number of factors that suggest that the emergence from the crisis will not produce the inflationary tendency suggested by Minsky, but rather the opposite.
- The first factor is the distinction between the structured assets that held the mortgages and the collateral underlying them. Fed lender of last resort intervention attempted to place a floor on asset prices,.
- It did not set a floor on house prices.

Validation of Dubious Financial Practices

- Rather than inflation, the biggest risk would seem to be the validation of financial practices that caused the crisis.
- Thus the need "to control, constrain, and perhaps even forbid the financing practices that caused the need for lender of last resort activity."
- This is the challenge that faces the US financial system, not the risk of inflation resulting from the lender of last resort activity or the support of household incomes through government stimulus.

An Alterntive Policy Assignment

- An inappropriate financing of investment and capital asset ownership are the major destabilizing influences in a capitalist economy. Thus the substitution of employment for investment as the proximate objective of economic policy is a precondition for financial reforms aimed at decreasing instability.
- **The emphasis on investment and "economic growth" rather than on employment policy is a mistake.** A full -employment economy is bound to expand, whereas an economy that aims at accelerating growth through devices to induce capital intensive private investment not only may not grow, but may be increasingly inequitable in its income distribution, inefficient in its choices of techniques, and unstable in its overall importance "
- Proposed Direct Government Employment Guarantee Program
- Functional Finance

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