Orthodox vs. Minskyan Perspectives of Financial Crises

Jesús Muñoz

1) Introduction

Modern (bond market) financial crises started in Mexico in late 1994. Initially these involved currency crises in which the pegged exchange rate regime had encouraged the generation of asset bubbles which then unearthed deeper asset market instability.

The so called 1st generation models (Krugman, 1979) and 2nd generation models (Obstfeld, 1994) of financial crises were created to explain the causes, consequences and remedies of this type of external debt crisis.

Subsequent crises in the 1990s required a sounder explanation and hence the 3rd generation models (Kaminsky & Reinhart, 1998) and the 4th generation models (Krugman, 2000; Tornell, 1999; Dornbusch, 2001) of financial crises arose.

Introduction

In the former the twin triggering factors are both exchange regimes and fragile banking systems. The 4th generation models concentrated on the effects of crises as they destroyed balance sheets of real and financial sector firms - ultimately affecting output and confidence.

Private, rather than government debt therefore became central to the explanation and remedy of crises. These most recent models were refined to include public debt as the initial cause of crises but with their consequences eventually affecting private claims.

The outcome is that the most recent generation of orthodox models superficially approach the theory of Minsky in explaining the mechanics of financial crises. Perhaps the principal difference between orthodoxy and heterodoxy (as represented by Minsky) is that the 4th generation models consider that shocks producing instability are exogenous to the system.

Introduction

We explore the differences between the orthodox and the heterodox views on financial crises, explaining in the process why conventional views of crises are not adequate to help in preventing and correcting them.

In the subprime crisis (global financial crisis) of 2007 with government budget deficits, monetary policy and 'money manager capitalism' in the financial markets all contributed to the crisis. The paper argues that a heterodox (deeper) analysis along Minskyan lines produces a more coherent theoretical and policy analysis of the new, and more complex financial crises.

Topics: Financial Fragility
Asset bubbles.

Topics covered

1) Introduction

2) Orthodox models of financial crises

3) Main similarities between orthodox and heterodox models of financial crises

4) Main differences between orthodox and heterodox models of financial crises

5) Conclusions

Orthodox models of financial crises I

2) Orthodox models of financial crises

The triggering factor is a financial asset that unearths the problems of the financial sector affecting the real sector and generating a crisis through perceptions.

1st generation models /exemplified by Krugman 1979) explain crises as the product of budget deficits. It is the need for seignorage to cover deficits that ensures a collapse in exchange rates trough a speculative attack on foreign reserves

2nd generation models (exemplified by Obstfeld 1994) explain crises as the result of a conflict between a fixed exchange rate and the desire ti pursue a more expansionary monetary policy

But emerging economies suffer from either the 'original sin' or the impact of moral hazard which is reflected on the exchange rate.

Orthodox models of financial crises II

- 3rd-generation models (exemplified by Kaminsky and Reinhart 1998) argue that the core of the problem lies in the banking system. Moral-hazard driven lending provides a a hidden subsidy to investment which collapses when the government withdraw their implicit guarantees

- 4th-generation models: (exemplified by Tornell, 1999; Dornbusch 2001 and Krugman, 1999) emphasize the role of companies' balance sheets and that of capital flows in affecting the real exchange rate.

- In Krugman 1999 investment and debt are linked but the linkages refer to developments in the real sector (consumption, investment and imports), neglecting the fact that investment is determined in the financial sector

Orthodox models of financial crises III

- Policy implications are prophylactic measures such as capital controls, and regulation
- In dealing with the crisis, it is necessary to stabilize the turmoil in the financial market in question, the provision of emergency lines of credit
- The orthodox model is silent about structural reforms, except by the construction of a new financial architecture (Frankel, 1999), bank restructuring and bank capitalization
- In the case of Mexico 1994 the crisis was produced by a combination of over-lending with a peg. It suffered from financial fragility arising in the real sector

Main similarities between orthodox and heterodox models of financial crises

3) Main similarities between orthodox and heterodox models of financial crises

- The crises start with a large and sudden reduction in the price of a main financial asset (exchange rates or subprimes), the size and fastness of this reduction reflecting the extent of the crisis and the loss of credibility as well as the reach of contagion

- Investment is the engine of the system and of the business cycles

- Emphasis on debt and on balance sheets

- The crises ultimately affect output (unemployment) and income distribution (inflation in emerging economies), see Baldacci et al. 2001

- Domestic vulnerability is relevant in both the industrial and the financial sectors

- The crises require reforms in financial sectors.

Main differences between orthodox and heterodox models of financial crises I

4) Main differences between orthodox and heterodox models of financial crises

- For orthodox explanations of financial crises, the system tends to equilibrium as in the Neoclassical world

- Atomicism is the assumption in orthodox models
  - Units or sectors are not interconnected, and agents are homogeneous
  - the real and the monetary sector are independent

- Orthodox explanations rely on exogenous factors
  - External factors (industrial problems, trade deficits, contagion, supply shocks) propitiate a crisis
  - Both money and uncertainty do not play a key role

Main differences between orthodox and heterodox models of financial crises II

- For Keynes there exists underemployment equilibrium, animal spirits, uncertainty and the economy functions as a unity. Keynes believes in organicism

- Minsky makes uncertainty operational, wherein booms generate busts through a tipology of debt, he analyzes the evolution of debt which result is that investment decreases and propitiates crises. This is the endogenous explanation of financial crises, which can be cured

- Minsky links investment and debt (cash flows and profits with commitments) within a historical time framework. Financial innovation and financial regulation exarcerbate problems in a system that is in permanent evolution

- The orthodox explanation is insufficient as:
  - Financial institutions are the essential part of the economic system not an irrelevant sector
  - Speculation is a triggering factor, not a cause but orthodox economists believe in rationality
  - Information deficiencies or co-ordination failures are not the cause of the problem
  - M^s is irrelevant and speculation is destabilizing

Main differences between orthodox and heterodox models of financial crises III

- In Minsky’s model, profits are highly relevant in the development of the crises, as well as the role of big government. The profit motive is not mentioned in the orthodox models, which assume perfect competition throughout the economy.

- For Minsky, banks and their structure must be reformed, whereas orthodox models assume the existence of efficiency in this sector with occasional deviations from rationality. However some orthodox models discuss the implications of short-term profits in the behaviour of banks.

- Orthodox models also mention mitsmatches in currencies or in assets composition, but they see them as an exception

Main differences between orthodox and heterodox models of financial crises IV

- Minsky links the asstes and the liabilities sides of the economy. This can be called the analysis of investment-cash flows sensitivities, where cash flows and debt are linked. The orthodox analysis separates investment from leverage decisions

- Investment and debt levels ultimately trigger a crisis, as in the FIH

- Whereas Keynes and Minsky are focused on behavioural finance, orthodox models following the neoclassical direction rely on equilibrium, efficient markets, perfect information and knowledge

Main differences between orthodox and heterodox models of financial crises V

- In a complex system there are causes, interrelations, consequences and prescriptions in the explanation of a phenomenon.
- If in the study of financial crises investment is the engine of the system and money its main emerging property, in the orthodox models causes are not deep, interrelations are simple (atomistic, direct and linear), and prescriptions are weak.

Conclusions I

5) Conclusions

- Minsky uses Keynes's concept of uncertainty, providing a deeper and superior explanation. Shocks are not random but arise from the heart of the system: money and the relevance of the financial sector

- Orthodoxy confuse symptoms with causes. This is a theoretical weakness

- The government determines the size of profitability in the private sector, but for the orthodox view its role must be limited to resolve crises

Conclusions II

- Policy prescriptions in Minsky are more accurate as they address problems in the financial sector that can be fixed by means of reforms and the provision of liquidity and solvency problems, considering the role of big government

- Orthodox theories are a repetition of neoclassical theories, where disequilibrium is an anomaly and money is a veil.

- A crisis is a situation that we cannot forget. How can a crisis be a normal situation?

Conclusions III

- Theories must be more real and deeper and must evolve according to the increasing complexity of the object of study (the financial system)