Revisiting the Unstable Economy

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MINSKY’S Early Contributions

- **Innovation is endogenous, responds to profit opportunity**
- **Innovation stretches liquidity, increases fragility**
- **Intervention validates innovations**
- **Institutions can act as ceilings and floors, constraining endogenous instability**
- **Institutions of early post war economy promoted stability; but stability is destabilizing**

Extensions: 1960s-1970s

- **JMK: financial theory of investment, investment theory of the cycle**
  - **2 Price system**
  - **Lender's and Borrower's risk**
- **Kalecki view of profits: I→Profit**
  - **Inv today forthcoming only if Inv expected in future**
- **Financial Instability Hypothesis**
  - **Apparent stability changes expectations and behavior in a way that generates fragility**
  - **Agents in the model have a model of the model**

Can "It" Happen Again?

- Anti-Laissez Faire Thm: "in a world where the internal dynamics imply instability, a semblance of stability can be achieved or sustained by introducing conventions, constraints and interventions into the environment."

- "These institutions in effect stop the economic processes that breed the incoherence and restart the economy with new initial conditions…".

- "The aptness of institutions and interventions will largely determine the extent to which the path of the economy through time is tranquil or turbulent: progressive, stagnant, or deteriorating."

The Policy Problem

- Stability cannot be achieved because it changes behavior in ways that make “it” likely

- “The policy problem is to devise institutional structures and measures that attenuate the thrust to inflation, unemployment, and slower improvements in the standard of living without increasing the likelihood of a deep depression”

- Relative stability of Post-War period led to development of Money Manager Capitalism—a much more unstable version of the “57 Varieties of Capitalism”

Evidence

- **Deep Recession but not Depression in 1975: Big Govt maintains income and profits**
- **Deep Recession but not Depression in 1982: Big Govt and Big Bank**
- **Reagan Recovery: Growth of Govt drives expansion with profits even without investment**
- **Bush Sr Recovery: Big Deficits**
- **Clinton Anomaly: Budget Reversal driven by private sector deficits and Irrationally Exuberant Dot.Com Boom**
- **Bush Jr Recovery: Big Deficits; Irrationally Exuberant Real Estate Bubble**

Money Manager Capitalism and the Real Estate Bubble

- Mngd Money needed returns when stock mkt tanked
- Fed low interest rate policy fueled mortgage market
- Banks, Mortgage Lenders had learned lessons from S&L fiasco: Securitize! Earn fee income and sell securitized mortgages

Innovations in Finance

New frontiers in Lending:

- -Mentally Retarded
- -Students (Student Loan Xpress and University Financial Aid Office = Loan Pushers)
- -Housing ATMs (cash-out equity)
- -Subprime Loans
- -Affordability Products: No Down, No Docs, Teaser interest rate, 40-50 Yr terms, Interest only, Liar Loans, NINJA loans

Securitized and sold to funds

Implications

Mortgage security mkt = $6.5T, bigger than Treas mkt

In 2001 Subprimes = 5% of mkt; 13% in 2003; 2006 = 35%
increased from $120B in 2001 to $600B in 2006;

In 2000 Average Subprime Loan = 48% of property value;
2006 =80%

In 2001 Liar Loans =25% of Subprimes; 2006 =40%

More than half of subprime borrowers took ARMs

In 2005 the majority of mortgages to African Americans,
and 40% to Hispanics were subprime

Ponzi Nation?

2002-2006: Total Credit increased \$8T;

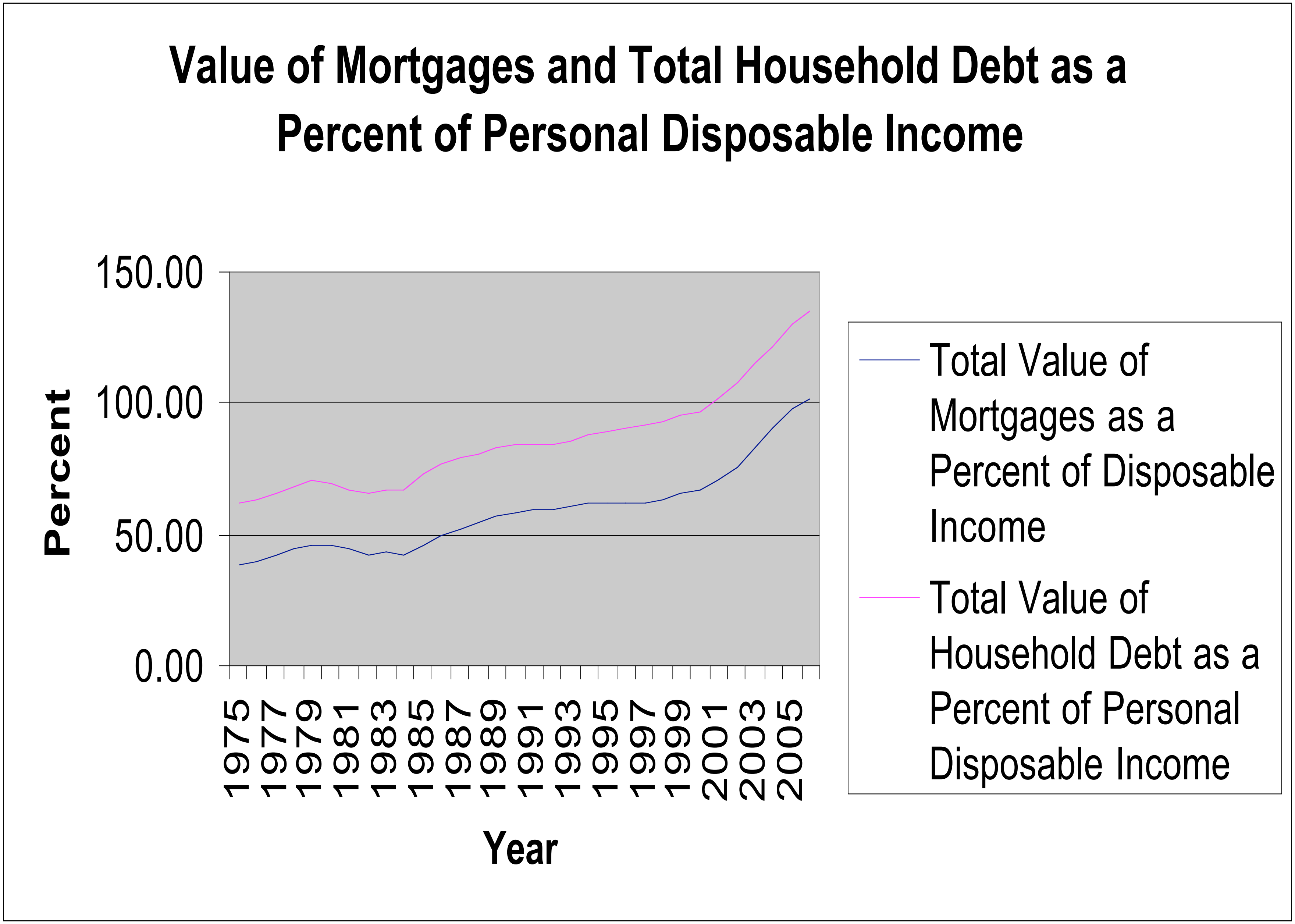
Mortgage debt increased 60% to \$9.5T
Subprime debt increased \$2T
GDP increased \$2.8T

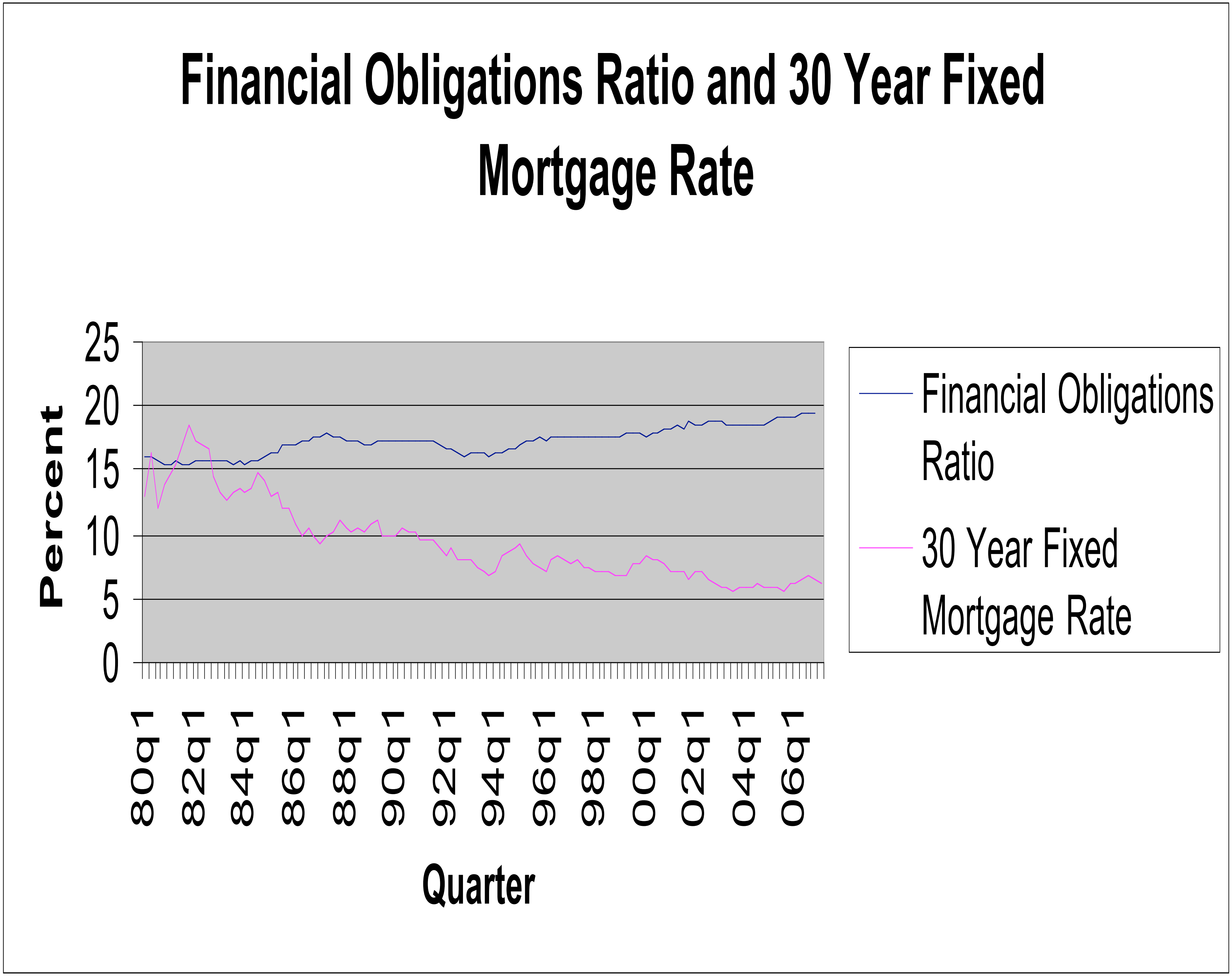
Household Sector Debt: 125% of GDP

Household borrowing (flow) peaked at 15% of DI

Cash-out mortgages reached \$500B/yr in 2005

For bottom half of income distribution, debt doubled from ’92 to ’04, to almost 100% of income; lowest income are most likely to use cash-outs for consumption


Value of Mortgages and Total Household Debt as a Percent of Personal Disposable Income
150.00
100.00
50.00
0.00
Percent
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
Year
Total Value of Mortgages as a Percent of Disposable Income
Total Value of Household Debt as a Percent of Personal Disposable Income

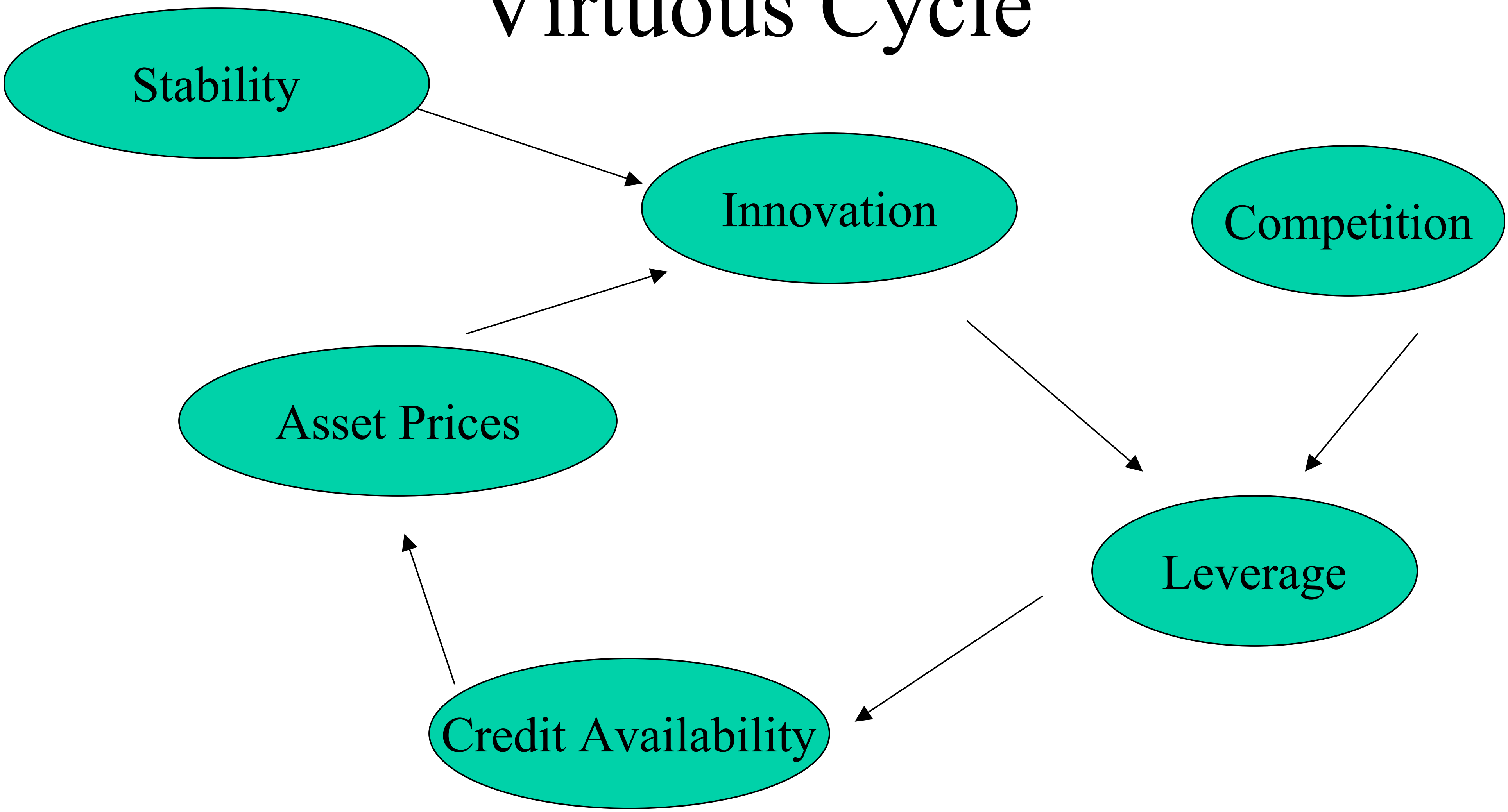


Financial Obligations Ratio and 30 Year Fixed Mortgage Rate
Percent
25
20
15
10
5
0
80q1
82q1
84q1
86q1
88q1
90q1
92q1
94q1
96q1
98q1
00q1
02q1
04q1
06q1
Quarter
Financial Obligations Ratio
30 Year Fixed Mortgage Rate

Why?

- Innovation → increase availability of credit → increase Price of Assets → can/must take on more debt
- The Greenspan “Put”: LTCM and Dot.Com bust → bailout, low interest rate, and implicit Twin Promise: No surprises, and Big Govt protection
- Clinton boom and shallow Bush recession → revised view of growth

Virtuous Cycle



Bernanke: The Great Moderation→ It can't happen again

- World is now more stable, due to:
  - Better monetary management: dampened inflation and business cycle swings
  - Globalization, absorbs shocks
  - Improvements in information technology
  - Rising profits, declining corporate leverage
  - Securitization→risks mangd and allocated
  - Derivatives ensure against risk

A Radical Suspension of Disbelief

Results

- Volatility of stocks and bonds hit lowest levels in 2006
- Corp bond spreads narrowed as price of risk fell
- Business failures declined
- Stocks are underpriced, can increase leverage
- Irving Fisher resurrected (asset prices can only go up, party like it's 1929)
- Campaign to increase competitiveness and efficiency by reducing regulation!

A Few Cracks Begin to Appear

- January 2007: 18% of loan officers tightened credit for mortages (but subprime auto loans still booming)—will exclude 1.1M buyers from mkt
- New Century, 2^{nd} largest Subprime failed; more than 2 dozen others have closed
- Mortgage delinquencies rising
  - By end of 2006, 2.6M mortgages 30+days past due or foreclosed
  - Over 13% of all subprimes past due
  - Alt-A delinquencies rising (39% of mortgages made in 2006)

Note: these problems are in new loans at teaser rates; problems will snowball when rates are reset

Median house price fell 3% last year; inventories up 20%; vacancies up 40%

Projected flat or falling sales at low-end retailers

Minsky's Agenda for Reform

- Capitalism is dynamic and comes in many forms
- 1930s reforms not appropriate for Money Mngr Capitalism
- Free Mkt ideology is dangerous
- New policies are needed to reduce insecurity, promote stability, and encourage democracy

Current Macro Challenges

1. Trade Deficit Leakage must be matched by Budget Deficit Injection, but Fiscal Stance is too tight
2. Growing inequality
3. Continuing budget shift toward transfers (Social Security), defense
4. Barriers to Work

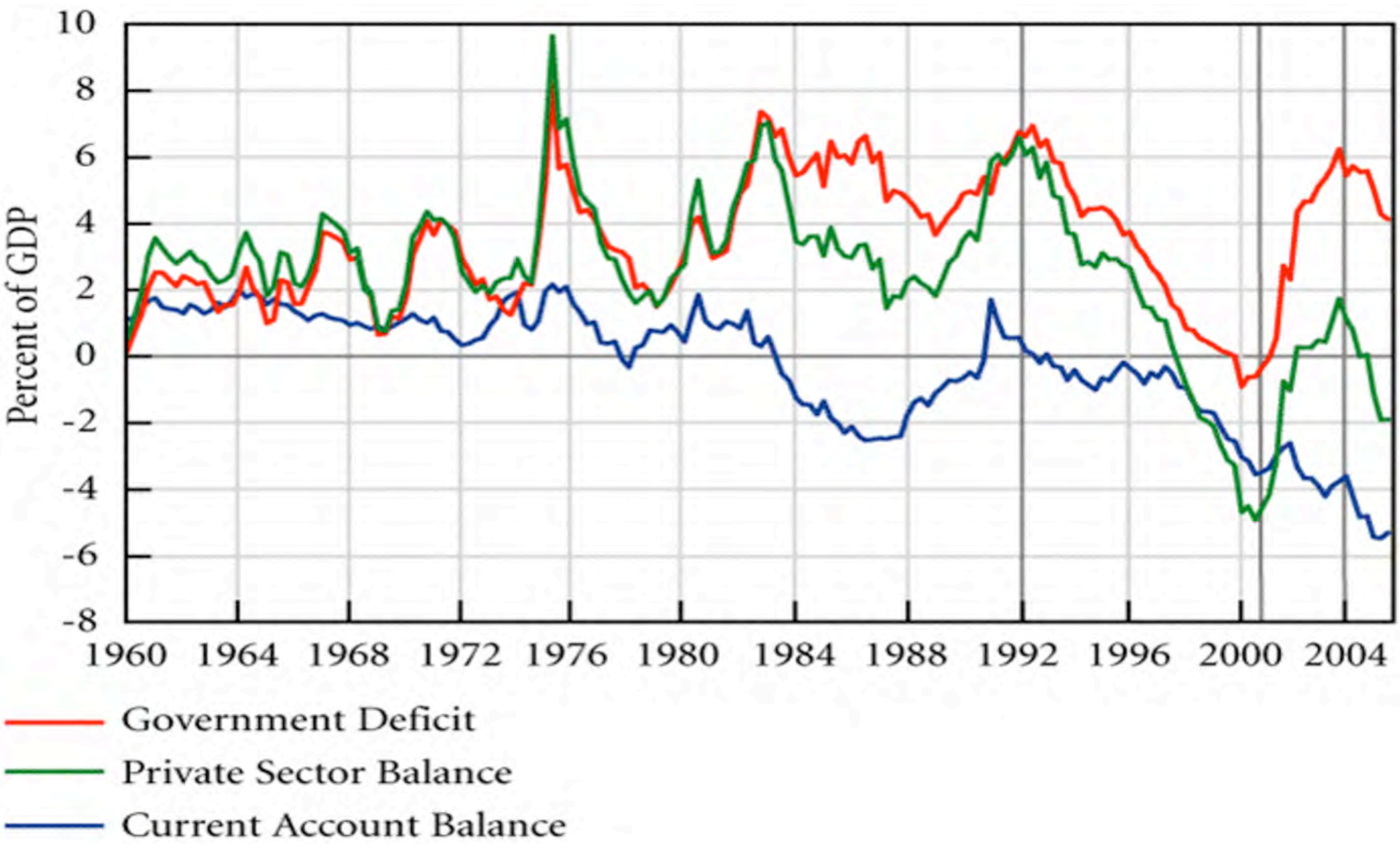
Accounting Identity of Financial Balances

$$\underbrace{\text{PRIVATE SECTOR BALANCE} + \text{GOVERNMENT BALANCE}}_{\text{INTERNAL FINANCIAL BALANCE}} = \underbrace{\text{CURRENT ACCOUNT BANCE}}_{\text{EXTERNAL FINANCIAL BALANCE}}$$

2005 THE BALANCE LOOKS APPROXIMATELY LIKE THIS:

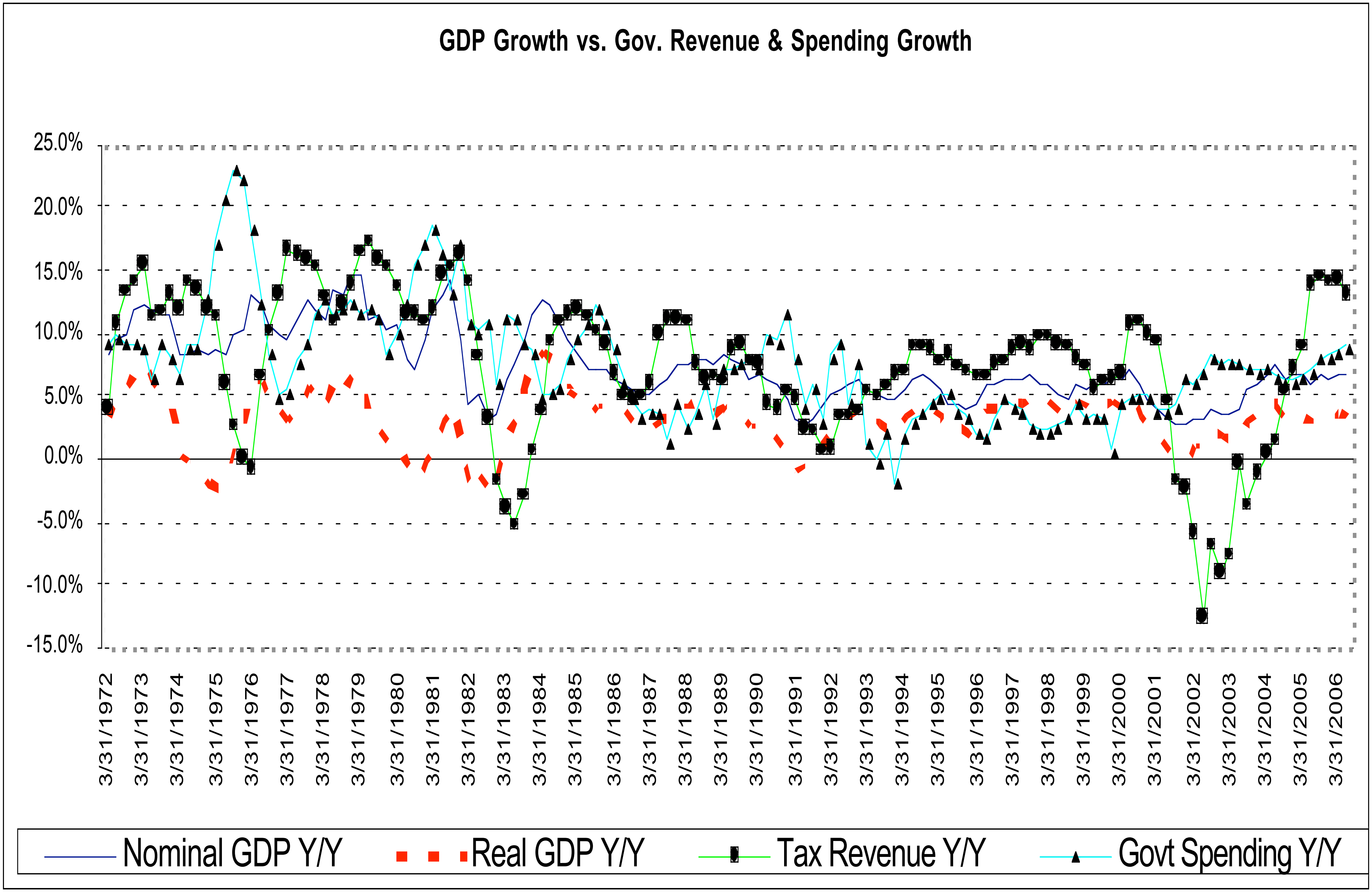
(PRIVATE) -2% + (GOVERNMENT) -4% = (CURRENT ACCT) -6%

External Deficit must be matched with Injection

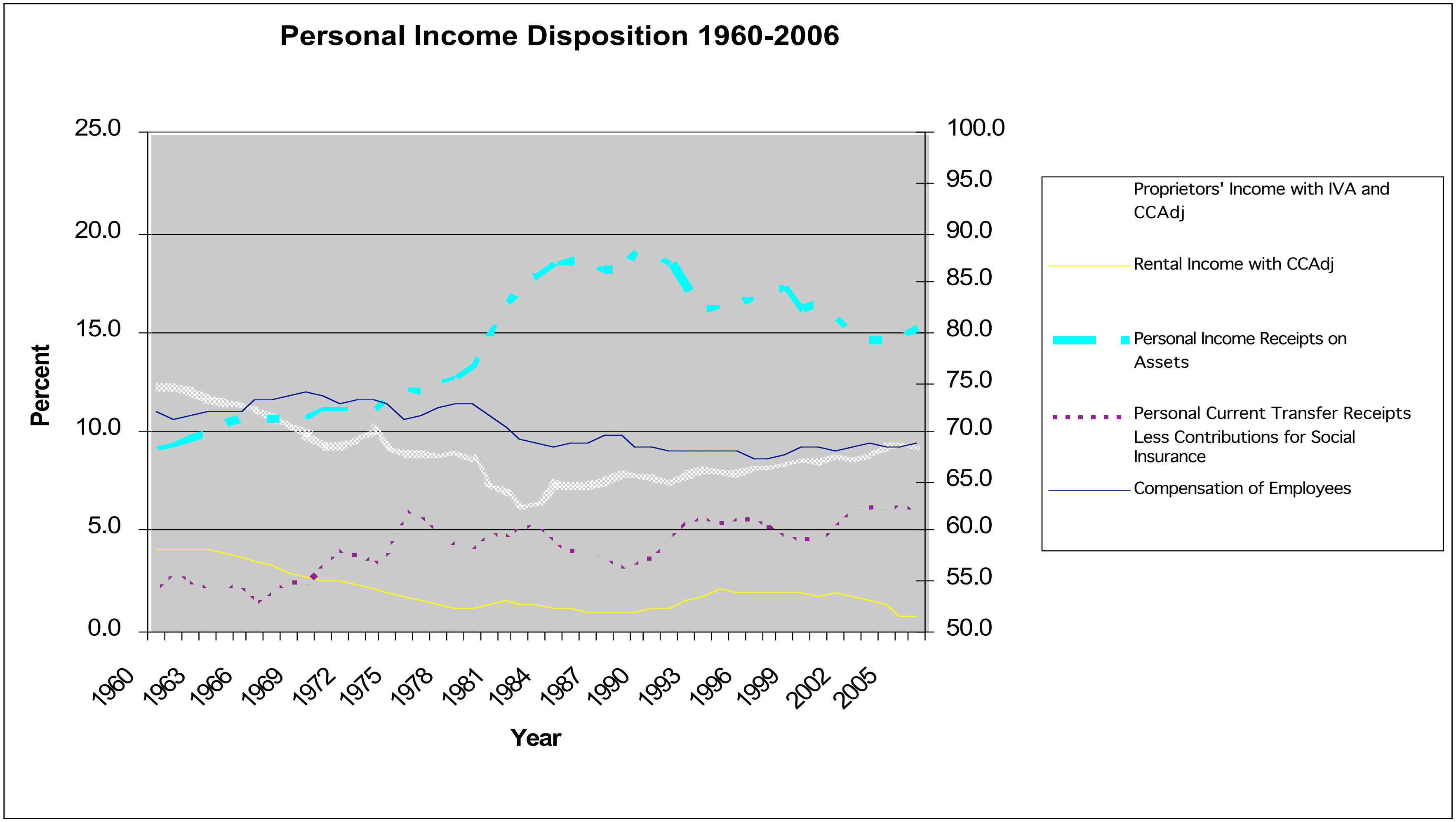


Sources: BEA and authors' calculations

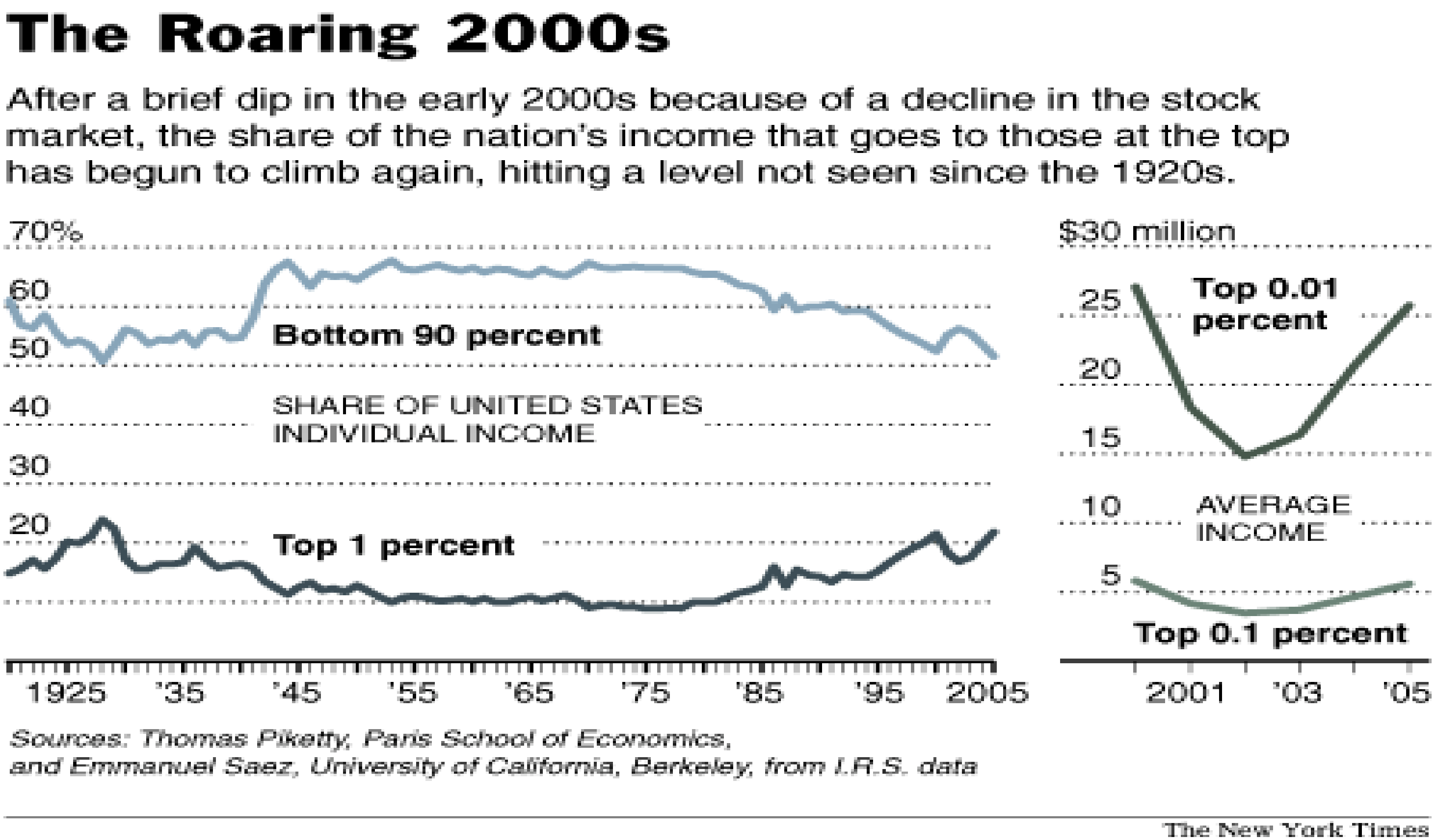
Current Fiscal Squeeze



Minsky: need high wage economy



Inequality of Distribution: top 1% and 10% have largest share since 1928; In 2005 income rose by 9%, but actually fell for bottom 90%



Transfers, overhead, and defense add to mark-up and inflation pressures

- International competitive pressures reduce overhead and some components of markup
- Net imports also reduce markup

- But aging of society increase transfers→ increase markup
- As does defense spending, consumption financed by debt, and high investment

Promote High Employment

- Encourage seniors to work
- Eliminate payroll tax
- Full employment through job creation
  - Perfectly elastic demand for labor
  - WPA, CCC, Youth employment
  - Provision of public infrastructure
  - Provision of social services
  - Universal: Employer of Last Resort

Open Economy: Can US Be Speculative or Ponzi?

US Current Acct Deficit approaching 8% of GDP.
US is world's biggest debtor. 2004: net foreign assets = negative $2.5 trillion (assets=$10 trillion; liabilities =$12.5 trillion).

US Private Sector: fragile, maybe Ponzi. But no reason to distinguish between domestic or foreign creditors.

US Government: services debt by crediting bank accounts; cannot be Ponzi.

If debts denominated in foreign currencies, situation would be different.

The US “Twin Deficits”—a synthesis

1960s: Need for growing government budget deficit to allow private savings/growth of net wealth

1970s/80s: US role as world’s banker—balance of trade deficit to allow ROW to accumulate dollar assets and service debts

Today: at full employment, budget deficit must offset current account deficit to allow private sector balance or surplus