21st Minsky Annual Conference
Introductory Remarks for the Minsky Conference
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I want to welcome you to the Levy Institute's 21st Annual Hyman Minsky Conference on "Debt, Deficits, and Financial Instability."

We are especially pleased to have the President of the ford Foundation open this year's conference. The Ford Foundation and especially Program Officer, Leonardo Burlamaqui, have been instrumental in their support of the Institute's program on Financial Instability and the Reregulation of Financial Institutions and Markets, and of this conference –not only by providing guidance and financial resources, but also hosting it here at the Foundation's attractive headquarters. The conference is an outcome of the Institute's research program on Monetary Policy and Financial structure headed by long-time senior scholar Jan Kregel. Jan inherited this research endeavor from the late Hyman Minsky who initiated it when he joined the Institute in 1990.

The Ford-Levy Institute project has undertaken an investigation of the root causes of the last financial crisis by drawing from Minsky's extensive work on financial regulation. Its focus is the assessment of the Dodd-Frank Act, enacted in the United States, almost two years ago, and other similar initiatives in the European Union, Great Britain and Latin America. It seeks to determine whether the new regulatory structures, once become operational will prevent a debt deflation and a systemic crisis from happening again. The guiding question is to what extent the Dodd-Frank Act in the United States will be capable of identifying and responding to what Minsky believed to be the inherent generation of financial instability.

The theme of this year's conference is reminiscent of one of the first conferences we held at the Institute in 1989 on "Profits, Deficits and Instability." At that time the issues confronting the US economy were similar: rising levels of public and private sector deficits and debt, current account deficits, and the less-developed-country (LDC) debt crisis and its eventual restructuring, i.e., the Brady bonds. The size and quantity of deficits and debt were quite high, and I remember Henry Kaufman worrying that the stock of debt in the United States in 1988 was getting close to $10 trillion.

Fast forward to 2012: we are confronted with large deficits and debt in the public sector and a stock of private sector debt that remains high despite ongoing deleveraging process from the borrowing frenzy—a frenzy that resulted from what many assumed to be an infinitely increasing housing market, starting almost a decade ago, and gone bust in 2007. On top of all this we have high unemployment rates, anemic growth rates, and a Eurozone sovereign debt crisis that dwarfs the LDC debt crisis of the late 1980s. These phenomena urgently require policy responses that are aimed at aborting or containing potential debt deflations.

In a modern, complex economy investment and financial transactions, in general, always entail an exchange of money in the present, used to pay for the creation of capital assets for money in the future, as those capital assets are employed. Investment, then, depends on financing conditions in concert with the current views, held by the representatives of business and banking communities, of future cash flows. The economy can be distinguished by expectations of cash flows and realizations by the business community that use private capital assets and need to fulfill contractual payment commitments. One would observe that both the capital and financing structures to be dependent on the past, the present and the future. Expectations and the consequent behavior are dependent on the economic model used: for instance, a model that assumes that economies like our own are normally successful will produce different behaviors compared to a model that assumes that what happened during

the Great Depression or in the 2007-2009 Great Recession were normal, albeit rare events that could happen again if the same circumstances were repeated.

Uncertainty in the minds of agents makes it difficult as to which of the two models is relevant in forming expectations, especially if many years have gone by since the last financial crisis associated with a significant economic correction. Memories fade fast and evolutionary changes, whether legislated, administered, or both, transform the economy's institutional structure. The past becomes less of a guide to the behavior of markets and agents, especially in a world where a Big Bank (central bank) intervenes to contain financial crises.

Subsequent to the shallow recession of 2001-2002, a euphoric period for the U.S. banking and financial community began. President George W. Bush's large tax cuts together with the Federal Reserve's Great Moderation approach to monetary policy changed the fiscal and monetary policy postures that helped increase both the government and private sectors' borrowing and debt, linked to the deterioration in the balance of payments. Indeed, there is a macroeconomic identity that links the internal (public and private sectors) and external (current account) balances, and although it is not a theory, it informs policy. Using this macro identity, the trajectory of the US economy can be predicted, and so it was. In late 2006, Levy Institute reports by the late Wynne Godley and others concluded that a recession was about to begin. In 2007, the prediction, unfortunately, came to pass.

Policy changes were suggested then, as they are being suggested now. In our latest Strategic Analysis report, although we recognize the very modest improvement in employment and conventional unemployment measures, we notice that employment nationwide has still not recovered to even February 2007 levels. As one of the speakers on the next panel has recently noted, the present rate of job creation, despite its improvement, is still insufficient to recoup the employment lost since the recession began or to provide enough jobs for the average monthly number of new entrants into the labor force. At this pace it would take many, many months to reach full employment. Hence, achieving a big improvement in the labor market will require much higher growth rates than those we are presently experiencing, and this can only come from increasing private and/or public sector demand.

Scholars at the Levy Institute are currently offering alternative options to achieve higher growth rates that are different from those assumed by the CBO and the executive branch of government. The plausible options are: either resuming private sector borrowing in amounts that are large enough that they will most likely result in another Minsky crisis and a significant risk to the country's still shaky financial system, or more realistically, a short-term public spending plan that includes the renovation of the country's tax structure. I won't go into the details of these policy options, but I ask you to visit the Levy Institute's website for the detailed assumptions and results of our intermediate-run simulations.

Let me then return to Minsky, who recognized the need for reconstituting the financial structure to be always in concert with the evolutionary nature of financial innovation. In 1989, Minsky wrote that the trajectory an economy follows through time depends upon the interactions between endogenous dynamics that will not necessarily determine a satisfactory path for the economy; nor will the constraints and interventions that make up the structure of regulation produce tolerable or satisfactory outcomes. It follows then, that over the longer run the satisfactory performance of a capitalist economy depends upon the aptness of the structure of regulation. Profit-seeking agents learn how a regulatory structure operates, and since regulation means that some perceived profit opportunities are not open to exploitation there are incentives for agents to change their behavior to evade or avoid the imposed constraints.

This implies that over time, the consequences of a structure and organization of intervention change. Interventions that start out being constructive can be transformed into sources of

instability and inefficiency. The debacle of securitization of mortgage-backed securities together with the slicing, and dicing of securities and the over-layering of derivative instruments, demonstrate that a structure of regulation and intervention that is initially successful can become perverse. The experience with mortgage-backed securities, the assortment of off-balance sheet special purpose vehicles, and credit default swaps is certainly not an argument for laissez-faire, but rather an argument that intervention cannot be frozen in time. It must adapt to evolutionary changes in institutions and usages. Successful capitalism requires both a structure of regulation and a sophisticated awareness of the way profit-seeking activities drive the changing of business and behavior.

Drawing from Minsky, in December 2007, an Institute working paper written by my colleague Jan Kregel pointed out that while almost every analyst thought the financial crisis could be contained, that

"the stage is set for a typical Minsky debt deflation in which position has to be sold to make position –that is, the underlying assets have to be sold in order to repay investors. This will take place in illiquid markets, which means that price declines and, thus, the negative impact on present value will be even more rapid. In this environment, declining short-term interest rates can have little impact,

When losses are reported to investors in sharply lower net asset values, they are certain to lead to massive redemptions by their institutional and pension fund clients. Since hedge funds are normally highly leveraged, this will put pressure on their lenders and their prime brokers—exactly the same banks that currently have to increase their lending in support of their Special Investment Vehicles and their holdings of senior tranches of collateralized obligations. They could choose to make margin calls on the declining value of the hedge fund assets pledged as collateral, but this would simply aggravate their existing problems.

.. the damage from a debt deflation will be widespread—borrowers who lose their homes, hedge funds that fail, pensions that are reduced—so the net overall impact will be across a number of different sectors. However, in contrast to what Alan Greenspan argued in defense of financial engineering to produce more complete markets—that it provided for a better distribution of risk across those who are willing to bear it—the risk appears to be highly concentrated in core money center banks who, at present, are increasingly unable to bear it.

The Fed's survey of lending conditions currently suggests that banks are curtailing lending and tightening credit conditions. This suggests that lending to households, whose spending in the current recovery has been financed by structured finance, is likely to decline dramatically. If the availability of household finance collapses, it is also likely that the long predicted, but never realized, retrenchment of consumer spending may become a reality, buttressed by the continued decline in the dollar, producing rising import prices. That, along with rising petroleum prices, will further reduce real incomes and make meeting mortgage debt service that much more difficult. The system thus seems poised for a Minsky-Fisher style debt deflation that further interest rate reductions will be powerless to stop.

The Fed has already stated that it will accept asset-backed commercial paper as collateral for discount window lending,…allowing [banks] to increase their lending to affiliates over existing limits. These measures, are all meant to avoid a "market" solution to the problem in the form of debt deflation. Given that the crisis appears to be similar to that which led to the breakdown of the financial system through debt deflation in the 1930s, a similar remedy in the form of a Reconstruction Finance Corporation and reregulation of the system would seem to be the most efficient means to prevent, in Hyman Minsky's words, "IT" [the Great Depression] from happening again."

This was written in 2007, and what was predicted came to pass. Washington's response to the

financial and economic crisis placed the government's full faith and credit on the line, became the subject of strong legislative debate, and changed the mood and makeup of Congress.

As we saw, as financial and economic uncertainties became more evident, the policy agenda turned to the creation of a financial structure that would be less subject to excesses of speculation and would promote the capital development of the economy. But it is doubtful that the Dodd-Frank Wall Street Reform and Consumer Protection Act will ensure control over speculation or ensure the support of enterprise.

So what do we do to establish a more stable financial system? Minsky had developed a set of ideas, a blueprint if you will, to reconstitute the financial structure. The Ford Foundation-Levy Institute project concentrates on these very Minskyan ideas and has published a series of papers drawing from the published and unpublished works that are in the Minsky digitized archive maintained at the Levy Institute that has been made possible by the financial support from the Ford Foundation and Andrew Sheng, President of the Fung Global Institute in Hong Kong. We especially want to bring to your attention this year's e-monograph on "Beyond the Minsky Moment: Where We 've Been, Why We Can't Go Back and the Road Ahead for Financial Reform." As always, we invite your close scrutiny of it and will welcome your comments.

Thank you very much for coming and enjoy the conference.