



Skepticism About Minsky's Financial Instability Hypothesis: A Comment on Flanders

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Hyman Minsky was an important heterodox monetary economist. His work has enjoyed increased academic and public attention since the 2008 crisis, manifestations of which include republications of his books, an *Elgar Companion to Hyman Minsky* (Papadimitriou and Wray 2010), and several blog mentions by Paul Krugman (e.g., 2009), in addition to the examples that June Flanders (2015) gives. From my perspective Minsky's writings are often insightful and thought-provoking, particularly as they concern developments in modern banking and finance. It is clear that he was on to something. But seldom do I find him persuasive about the causes of observed developments. Flanders's paper, based on a diligent study of the online archive of Minsky's unpublished work, provides a useful introduction to his views. Where her account of Minsky's argument seems to involve non sequiturs, the fault is generally due to Minsky rather than to Flanders.

In an earlier survey of Minsky's thought, Perry Mehrling (1999, 129) rightly noted that Minsky was rooted in "the American institutionalist tradition of monetary thought, a tradition deeply influenced by roots in American progressivism." Mehrling observed that Minsky drew ideas from four prominent economists: Henry Simons, from whom he took an antipathy to debt finance; Oskar Lange, from whom he took market socialism as an ideal; Alvin Hansen, from whom he took a Keynesian emphasis on aggregate demand failures; and his dissertation ad-

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viser, Joseph Schumpeter, from whom he took the idea that entrepreneurial capitalism subverts its own institutions.

Flanders (2015, 89) offers a more surprising comparison: “In some respects Minsky’s analysis is not unlike Hayek’s.” I see some commonalities. Both Minsky (1994) and Hayek (1931) put intertemporal coordination failure at the heart of business cycle crises. The crisis reveals a mismatch between the plans of debt-financed investors—that is, plans to sell future output for enough revenue to repay the debts incurred in financing their projects—and the plans of consumers—that is, plans to buy future output at such cost-covering prices. Both Minsky and Hayek (under certain conditions) propose that the commercial banking system, independently of the central bank, can be expected to act in a way that amplifies cyclical fluctuations in the economy. For Hayek, however, this is only one of three possible scenarios (and the only one in which one can say, as does Flanders, that Hayek treats money as endogenous). Hayek gives more emphasis to two other scenarios in which exogenous money injections by the central bank (either to lower interest rates, or to stop them from rising in response to an increased demand for loanable funds) are to blame for interest-rate distortion and intertemporal discoordination. For Minsky, by contrast, the commercial-banking amplification of fluctuations is essential. It is the foundation of what he calls the “Financial Instability Hypothesis.” Minsky slights or rejects the normal role of the financial system in coordinating intertemporal plans, a role that Hayek (2007/1941) emphasized in his debate with Keynes.

Hayek’s arguments for expecting disequilibrating commercial bank behavior are weak, (White 1999a; 1999b), and for like reasons so are Minsky’s. Essentially, they rest on implausibly non-optimizing behavior by bankers, plus an unexplained failure of freely determined interest rates to clear intertemporal markets. We do not get a satisfactory account of why, in the absence of exogenously shifting constraints, we should find investors, in Flanders’s words, “systematically behaving in a way that leads to increasingly speculative activity” (2015, 85).

Minsky’s analysis shares a few features with the banking analysis of the modern free banking school. Neither is institutionally antiseptic. Both stress the importance of a sound monetary and banking system for macroeconomic stability. But the two views differ in fundamental respects. Following Henry Simons, Minsky considers debt-based finance, and *a fortiori* debt-funded intermediaries like banks, to be *inherently* unsound. He recognizes no tendency in the financial system toward intertemporal equilibrium, even in the absence of external disturbances. Instead the financial system tends to puff itself up until it explodes. In Minsky’s words, a “theorem [of the financial instability hypothesis] is that, over periods of prolonged prosperity, the economy moves from financial relations that make for a stable system to those that make for an unstable system” (1994, 157). In contrast to

George Selgin (1988) and myself (White 1999c, ch. 3), Minsky offers no baseline model of equilibrium in a competitive banking system. His theory of free banking, unrestricted and unprivileged, is entirely undeveloped and hence unavailable for critical scrutiny (see Selgin 2014).

Minsky refers to “money of the kind we have, which is created by banks as they finance capital asset production and ownership” (1982/1978, 91). It is important to recognize that we actually have two kinds of money today, the kind issued by commercial banks (checking account balances, which are IOUs) and the kind issued by the state (fiat money units, which are IOU-nothings). It would be a mistake to think that we only have the first kind. It would also be a mistake to think that the volume of checking account balances identically equals the volume of bank loans, or that banks automatically issue money in amounts corresponding to the quantity of investment and housing loans demanded by approved borrowers. Banks fund loans with non-deposit as well as deposit liabilities, and they intermediate deposit liabilities into non-loan assets (e.g., by holding reserves or bonds) as well as into loan assets.

Absent accommodative central bank intervention to enlarge the quantity of base money (currency plus bank reserves), the first effect of an increase in the demand for loanable funds is to drive up interest rates. The volume of commercial-bank-issued money increases only to the (possibly minor) extent that the public wants to hold additional monetary deposits (per unit of base money) at higher interest rates. Because market forces constrain the quantity of commercial-bank-issued money, it is not a market-disturbing kind of money. Disturbances come rather from central bank actions, particularly changes in the volume of base money.

Part of the reason that Minsky’s work is hard (at least for conventional and Austrian economists) to follow is that he does not reason in terms of the supply and demand for money, nor in terms of monetary equilibrium and disequilibrium. For reasons I don’t grasp, he rejects even the basic Quantity Theory propositions that for a fiat money economy (1) there is a price level that clears the market for money balances, and (2) in a *ceteris paribus* comparative statics thought experiment the quantity of money is neutral toward real variables. Minsky writes that the “innovative characteristic of banking and finance invalidates the fundamental presupposition of the orthodox Quantity Theory of money to the effect that there is an unchanging ‘money’ item whose velocity of circulation is sufficiently close to being constant” (1994, 156). The statement suggests a serious misunderstanding of the theory. The Quantity Theory is a *ceteris paribus* theory. It isn’t refuted by saying that in practice other things do not remain equal over time.

Moreover, understood in comparative-static terms, the Quantity Theory does not rest on any presupposition that the velocity of some monetary aggregate remains close to constant over historical time. All that rests on such a presup-

position is the claim that constant growth in a monetary aggregate (viz., enactment of Milton Friedman's 'k-percent rule') will yield a constant rate of inflation. But that is something distinct from the Quantity Theory.

Whether the nominal revenues of firms are sufficient in the aggregate for them to repay bank loans at a normal rate (and default at a normal rate) depends in part on whether the public's nominal spending is great enough. Minsky does not use the equation of exchange to decompose the size of nominal aggregate demand into the quantity of money times the velocity of money, but rather, in Keynesian C+I+G fashion, he takes aggregate demand to vary mostly with aggregate investment. Declining to think in terms of the equation of exchange, or the supply and demand for money, prevents Minsky from offering a satisfactory explanation of inflation. As Mehrling (1999, 146) notes, "Inflation was difficult for Minsky to understand because of the thoroughgoing nominalism of his thought. ... In Minsky, there is no margin along which the 'real' value of money might be established." Institutionalism without reference to the rate at which the quantity of dollars is growing simply doesn't explain the rate at which the purchasing power of the dollar is being diluted, that is, the inflation rate.

Minsky offered a three-fold distinction among banks' default risk positions, referring to "hedge," "speculative," and "Ponzi" positions. Basically, "hedge" finance means low leverage and a very low risk of default, "speculative" means higher leverage and higher risk, and "Ponzi" the highest leverage and the highest risk. Fragility in the banking system grows if banks shift toward higher risks of default. That much is a classificatory truism, not an explanatory theory. There would seem to be potential non-truistic explanatory power in the Financial Instability Hypothesis (FIH), which proposes that a banking system *tends on its own* to move from robust to fragile. In Mehrling's account, "this is so because in a world of uncertainty, especially endogenous uncertainty, expectations about the future have little objective foundation so that mistakes are inevitable" (1999, 141).

But the FIH does not in fact follow from uncertainty. Mistakes do not imply a systematic tendency in one direction. It needs to be explained why mistakes are not randomly distributed around an unbiased mean. We should expect systematic mistakes to trigger correction mechanisms. A natural stochastic equilibrium concept is therefore that of a system where the realized frequency of borrower defaults varies randomly around the expected frequency of defaults, creating no chronic tendency toward increasing banker optimism (or pessimism). As George Stigler (1984) once noted, attributing something to errors isn't a helpful explanation "unless I manage to explain when errors are made and why and what kind...since one of the graceless things about errors is that they can come from anywhere and go in any direction."

If, in standard fashion, we regard banks as optimizing agents, then to explain why they shift to riskier positions we need to appeal to parameter changes that cause them to change their chosen positions. What prompts banks to “drift to” speculative activities, as Flanders (2015, 92) puts it, when they do, and not sooner, given that they could have been pursuing those activities all along?

Note that the observed instability in *current-day* banking regimes is not *prima facie* evidence for the hypothesis that a banking system *makes itself* fragile. Current-day systems are characterized by central banks and other government agencies with the power to disrupt the system.

Accordingly, an appeal to swings in investor optimism/pessimism or ‘animal spirits’ is not wrong, so much as it merely pushes the question back one stage: What explains the swings in investor enthusiasm? In the main Mises-Hayek scenarios, it is variations in central bank policy that enlarge or narrow the apparent prospects for profitable investment. Somewhat more generally, to use Roger Koppl’s term, “Big Players” in the economy can stimulate investment through cheap money or targeted tax cuts, or discourage it through tight money, tax policy, or greater regime uncertainty (see Koppl 2014, 130-131; van den Hauwe 2014). Koppl rightly notes that, by contrast to the Big Player approach, “The financial fragility hypothesis of Hyman Minsky does not have a clear mechanism or clear empirical implications” (Koppl 2014, 40 n.12).

Mehrling (1999, 145) describes Minsky as concerned that, with a decline in animal spirits, investment spending will collapse and thus “reduce aggregate demand and so also aggregate income sufficiently that cash flows elsewhere in the economy fall short of their expected levels, so turning hedge finance units into speculative units, speculative units into Ponzi units, and so increasing the fragility of the system.” To the extent that causation runs *from* a reduction in nominal aggregate income (for whatever reason) *to* an increase in financial fragility—which is certainly a plausible linkage—then financial fragility is a symptom of macro-economic trouble rather than an independent and self-feeding source of trouble. What banks experience is not mood swings that lead them to take positions of greater risk, but bad draws in the optimizing risk positions they have already taken.

It would also be a non sequitur to conclude from the FIH, were it to survive empirical evidence, that on cost-benefit grounds the government should be assigned either the task of correcting bank finance strategies in good times or the task of providing a lender-of-last-resort safety net in bad times. Government agents assigned such a task might be no less immune than investors to waves of optimism and pessimism, and as a result might (say) encourage greater leverage in housing finance in good times. It might be that an official lender of last resort facing no insolvency constraint, such as the Federal Reserve Bank of New York, becomes captured by the major banks who stand to benefit from bailouts and forbearance.

A lender of last resort might generally create moral hazard costs in excess of its benefits. My hypothesis is that, in practice, the behavior of official regulators and lenders of last resort is *not* wiser or more prudent than that of bankers—or private clearinghouse association officers—with skin in the game, who are left unrestricted but also unsheltered.

I find that David Prychitko (2009) and Ludwig van den Hauwe (2014) usefully contrast Minsky's FIH to the Austrian theory of the business cycle. Unlike the Austrians, Prychitko (2009, 200) notes, Minsky neglects "the role that money plays in initiating the cycle by distorting relative prices within the capital structure." As a result, "the so-called Minsky moment—a feature of the recent housing bubble—is something that the Austrian theory of the cycle is already fit to explain" (*ibid.*). To explain an episode of increasing leverage, as seen in investment banks during the 2002–2007 housing bubble, an Austrian account points mainly to two factors: (1) cheap-money central bank policies that fed rising housing prices, which reduced current defaults and perceived default risks on mortgage-backed securities; and (2) with other neoclassical economists, housing-finance policies that increased morally hazardous behavior by lenders and borrowers. Flanders (2015, 100-101) quotes Minsky as recognizing the moral hazard factor created by too-big-to-fail policies, but not the cheap-money factor. Van den Hauwe (2014, 21) notes that both Minsky and the Austrians see trouble building during the upswing, whereas Keynes focused on the problems of the slump. But where the Austrians look to decentralized and competitive monetary and banking institutions to constrain the unsustainable boom, Minsky pins his hopes on better behavior by the big players: regulatory, monetary, and fiscal policymakers.

To evaluate possible reforms, we need to ask: Which institutional arrangements foster more financial fragility, which less, and why? To answer those questions it helps to look across different historical banking regimes to see where fragility was less, a method neglected by Minsky and Flanders. Doing so will be an eye-opener to anyone who thinks that banking is inevitably fragile. The broad lesson I draw from comparative historical studies (Cameron et al. 1967; Dowd 1992; White 1995; Briones and Rockoff 2005; Calomiris and Haber 2014) is that free banking systems are naturally robust—or even antifragile (White 2013). In such systems the banks that behave prudently, with adequate capital, liquidity, and diversification of assets and liabilities, are the banks that survive. Crisis-prone banking systems are those in which legal restrictions and regulatory institutions have weakened banks' incentives or muted the survival advantage of operating prudently.

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A Comment on Flanders. Lawrence H. White. Minsky's financial instability hypothesis. If, in standard fashion, we regard banks as optimizing agents, then to explain why they shift to riskier positions we need to appeal to parameter changes that cause them to change their chosen positions. What prompts banks to "drift to" speculative activities, as Flanders (2015, 92) puts it, when they do, and not sooner, given that they could have been pursuing those activities all along? Note that the observed instability in current-day banking regimes is not prima facie evidence for the hypothesis that a banking system makes itself fragile. Cur Minsky's Financial Instability Hypothesis. Wed, Mar 26, 2014 - 8:58am. By John Mauldin. Chairman of Mauldin Economics, & President, Millennium Wave Investments. Looking back, I see that I have mentioned the name Hyman Minsky in no fewer than ten Thoughts from the Frontline letters in just the past two years; and his name has popped up in all four letters so far this month, most notably on March 1, when we brought back one of my most popular pieces, "Black Swans and Endogenous Uncertainty" (the Minsky's work was roundly ignored by the economics profession and policy makers alike until all hell broke loose in the financial industry and then the global economy in 2008. At the time (in Dec. 2007), I described Minsky's thesis like this Essence of Minsky's Financial Instability Hypothesis: The main purpose of the conventional economic theory has been to show that the market economy is self-regulating and there is little need for any kind of intervention by the government. This has been the purpose of economic theory ever since Adam Smith gave the first systematic exposition. Prices, according to Post-Keynesians cannot be corrected because markets are likely to be destabilizing as stabilizing. Hence, the need for economic policies by the government and their intervention for active management of the economy. Therefore, Hyman Minsky criticized "neo-classical synthesis" and develops a novel theory of the working of capitalist economies. Minsky, Hyman P. Ph.D., "The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to "Standard Theory"" (1975). Hyman P. Minsky Archive. 38. https://digitalcommons.bard.edu/hm_archive/38. Financial Instability proofs.pdf (626 kB) Financial Instability Nebraska.pdf (639 kB) Financial Instability Challenge.pdf (820 kB) Financial Instability (1977).pdf (853 kB) Peterson's letter.pdf (110 kB) Minsky's letter.pdf (25 kB). Download. DOWNLOADS.