Minsky on Financial Innovation and Instability

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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by Allan H. Meltzer

The more appropriate title for this paper might well be, "Minsky's Stream of Consciousness on August 6." The paper touches on so many issues that it is not difficult to find some topics on which my judgments and Minsky's coincide and some on which they differ. This is an obvious advantage for a discussant who wishes to pick and choose, mixing a polite comment here with a slight growl there. The problem is that Minsky's ideas are presented in such a sketchy fashion that it is often difficult to be certain what he is trying to say.

An example is the lengthy, and for me, non-informative discussion of hedge, speculative and Ponzi finance. I don't understand Minsky's distinction (pp. 17-18) between the two last categories. Both types end with default on the principal. More basic is his failure to distinguish between expected and actual outcomes. Bankers, like the rest of us, draw their results from distributions. Some of their loans end in default and must be written off or worked out. With hindsight, it is easy to see that the price of oil is less likely to reach one hundred dollars a barrel in the next five years than many borrowers and lenders believed a few years ago. Perhaps estimates based on accelerating inflation will prove to be as foolish. Perhaps not. When major changes in relative prices or rates of inflation occur, we can expect to hear a great deal about bad judgment and risky loans.

What does this tell us about financial innovation? How did Penn Square innovate? Their failure seems to be an age-old story with differences confined to specific details. Did the loans to Poland lose their present value because some Ponzi scheme failed? Or, is the problem with the Polish,
Mexican, Penn Square loans, and many others, that the lenders believed that governments and central banks would underwrite the failures, so the actual risk was perceived to be small. And, if the pleas for international and domestic bailouts are answered, the taxpayers may yet have the privilege of sharing the losses or paying for all of them.

I am most certain about two issues, but my interest is piqued by an offhand remark, so I continue with what may be a digression or may be a restatement of Minsky's theme. Then I take up the two issues and the problem of instability in the current era.

What I take to be an offhand remark is on pages 3 and 4. There Minsky ruminates about the "greed unleashed in 1981" by the Reagan administration. This unleashing of greed produced an economic system in which "a Great Depression is possible." And, on page 4, Minsky repeats "another Great Collapse can become possible..."

These paragraphs convey the idea that before 1981, a major depression (or perhaps Major Depression) had become impossible. This would not be worth mentioning except that it is being said by the same Minsky who warned us repeatedly throughout the very same period that we were headed for another collapse.

The reason he changed his mind is obscure, but not more so than much of the rest of his message. I can reconstruct this much. Capitalism produces crises as a result of excessive expansion supported by credit and monetary expansion. The latter is caused, or perhaps abetted, by financial innovation. Institutional structure can prevent the crisis from occurring, and in recent years, two elements of the structure prevented crises. One is the size of government and the built-in stabilizers, particularly the
rise in the deficit during recessions. The other is timely action by the lender of last resort.

Stripped of the language and obscurantisms that Minsky uses to convey his message, this is straight from the textbooks of the fifties and sixties. The message is that the private sector is unstable, but discretionary monetary and fiscal policy and built-in stabilizers keep recessions mild. Arthur Okun, surely a mainstream economist of the time, exulted at one point that in the 1960's the Commerce Department's monthly BCD had changed its name from Business Cycle Digest to Business Conditions Digest because of the success of policy.

What is it that has changed? The Reagan administration has not reduced the size of government and cannot be charged with eliminating deficits. The administration and the Federal Reserve have just presided over an unprecedented series of mergers to prevent failures of a large number of depository institutions. It is true that the mergers are not "lender of last resort" loans. The lender of last resort lends to the market. It does not underwrite or share in the losses of insolvent institutions. Although the distinction is important, because the recent "bailouts" encourage lenders to underprice future risks, it is not a distinction that Minsky makes.

I turn now to the first issue that I promised to address. On pages 24 and 25, Minsky writes that the Federal Reserve cannot control the money stock and serve as lender of last resort. This is why he suggests that our choice is either inflation or depression.

His argument is incorrect, and his conclusion does not follow. The lender of last resort doesn't lose control of the money stock. The lender prevents a rapid decline in the money stock by providing base money or reserves
to offset a decline in the money multiplier. The lender does not lose control of the money stock. He maintains control. In a fractional reserve banking system a sudden increase in the demand for currency at many banks, can be met if the lender of last resort increases the monetary base. This does not cause inflation. It prevents deflation, or rapid disinflation.

The second issue I want to discuss is Minsky's proposal, at the end of his paper, that banks be permitted to hold equities. I am not opposed to banks buying any asset they wish, but I would not want to subsidize the risks by selling deposit insurance at a fixed price as is now customary. The reason is that the banks liabilities are fixed in nominal value. If a substantial part of a bank's assets are real assets, every price level change has a heightened effect on the value of the bank. Banks that choose to take risks of this kind should be permitted to do so, provided the stockholders bear the residual risk and depositors are permitted to receive interest on their deposits to compensate for the risk they bear. Without these changes in regulatory practice, I see no merit in the proposal. It encourages banks to underestimate the risks they accept.

Minsky has been writing about financial instability for many years. His paper reminds us that he discussed some of these issues in 1957. Yet, to my knowledge he has never produced a clearly stated hypothesis about the causes of instability or any evidence that would discriminate between various views.

The quarter century since 1957 is a not insignificant part of the economic history for which we have detailed and fairly accurate records. Most studies show this period to be the most stable period. Robert Gordon's computations of the standard deviation of departures from the trend growth rate of real
output in the United States is 33% lower for the postwar years than any comparable period. 1/ Until 1965, inflation remained low.

Postwar quarterly or annual variability of velocity is smaller than in pre-war decades. Financial innovation has not produced either a substantial trend, or a substantial change in trend, from the fifties to the eighties. Nor is there any evidence that -- despite the effects of controls, regulations and inflation -- velocity growth has become more variable. A most surprising fact about the trend growth of $M_1$ velocity in the seventies, is that it is not significantly different from the growth rate experienced in the fifties.

There are, I believe, many ways in which stability can be increased and risk reduced. I cannot agree with Minsky that inflating is one of them. There is now considerable evidence of a positive association between the variability of inflation and the level of inflation. There is a growing body of evidence that inflation has real costs. 2/ Minsky ignores all of this work.

There is no reason to be satisfied with the present level or risks or to ignore opportunities for improvement. High on my list of destabilizing financial practices are rules like Regulation Q, the non-payment of interest on required reserves, differential reserve requirements, lag reserves accounting and improper seasonal adjustment. During a period of inflation, many of these regulations increase fluctuations and variability. Does anyone doubt that the thrift industry would never have reached the position it did, or that money


2/ Much of this evidence is discussed in Alex Cukierman, "Relative Price Variability and Inflation." Carnegie-Rochester Conference Series (forthcoming).
market funds, offshore banking and much of the rest of the so-called innovations would not have occurred if the regulations of the kind just cited had never been imposed? It is perhaps a fitting final comment on the level at which Minsky addresses the problem of instability that none of these regulations is mentioned.