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Hyman Minsky

and

Financial Instability

Working Paper No. 23

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Abstract: Hyman Minsky can readily be categorized as a post-Keynesian economist, for he advances a purist's interpretation of John Maynard Keynes' *The General Theory of Employment, Interest and Money*. Through employing a rigorous Keynesian framework, Minsky developed an enduring contribution to the literature bearing the title: "The Financial Instability Hypothesis" (1992), that appears as *Working Paper No. 74* at the Jerome Levi Institute. In this document Minsky considered forces and variables that induce financial instability—that are also specific to advanced capitalist economies. He challenges the classical economists and the notion that a general equilibrium will prevail. Instead, Minsky goes on to teach us that the actions of businesses, banks and government, working hand-in-hand, serve to perpetuate cyclical, financial instability—defined by inflationary and deflationary periods.

***Journal of Economic Literature* Classification Codes:** B3, E3, P1

Key Words: Capitalist Systems, Financial Cycles, Financial Instability Hypothesis, Hyman Minsky, John Maynard Keynes

This inquiry seeks to convince the reader that in his *Working Paper No. 74* prepared for the Jerome Levy Institute, and that is entitled “The Financial Instability Hypothesis”, Hyman Minsky considers forces and variables that generate cycles in advanced capitalist economies. Minsky teaches us that capitalist economies typically display cycles that are characterized by periods of inflation that are followed by painful, deflationary periods. Minsky’s hypothesis of these ongoing cycles challenges notions of a self-sustaining general equilibrium advanced by Léon Walras, in particular. I shall begin this inquiry by emphasizing Minsky’s scholarly appreciation of John Maynard Keynes’s contributions found in *The General Theory of Employment, Interest and Money* [1936]. Second, I shall focus upon Minsky’s regarding how it is that financial crises unfold. Third, I shall further elaborate upon Minsky’s understanding of financial cycles in capitalist economies.

Minsky's Keynesian framework

Minsky defines himself as a post-Keynesian in the proposer sense, and this means through offering specific references and quotes borrowed from the text of Keynes' *General Theory.* Minsky (1992, 1) emphasizes that his financial instability hypothesis can be seen as "… an interpretation of the substance of Keynes's 'General Theory'" (1992, 1), but so of adoration of Keynes is riddled throughout all of Minsky's scholarly writings. To better understand the financial instability hypothesis, it is imperative to understand the Keynesian foundation upon which Minsky built his hypothesis. In the preface to his *Stabilizing an Unstable Economy* (1986), Minsky (1986, xiv) mentions that although his work can be described as "post-Keynesian", he uses Keynes's work as the shoulders of a giant, upon which he can stand and which helps him to see further and more clearly, and not as simply dependent on the works of the "Great Man".

In reading his book, *John Maynard Keynes*, Minsky (1975, 7) teaches us that Keynes studied at Cambridge University, and was neither a traditionalist nor a Marxist. Minsky (1975, 7) then describes Keynes as one who was on the "left," but was not extreme and he his positions tended to reflect his appreciation for the middle ground. During the Great Depression, many classical economists were scrambling to explain the economic downturn as a result of weak regulation in the financial system, as well as errors which were avoidable with proper policy prescriptions. In the view of Minsky (1975, 6), the most prominent among these economists was Henry Calvert Simons of the University of Chicago, whose view was that the Great Depression did not register as a systemic flaw arising within the capitalist system. Minsky (1975, 8) states that, to the contrary, Keynes correctly pointed out that the Great Depression was indeed a symptom of the inherent flaws in the capitalist system. Keynes went so far as to argue that nothing could be done to avoid cyclical depressions in a capitalist economy, and only good policy could help to control these depressionary periods. According to Minsky (1975, 6), the economists were failing to address the root cause of the depression, namely, the system itself.

It was during the seventh year of the Great Depression, in February 1936, that Keynes had published his magnum opus, *General Theory*. Keynes' book endeavors to clarify the cyclical nature of an advanced capitalist economy, and also to note realistic policy prescriptions and analytical tools that could be used to address the issues arising with these cycles. The crux of the cyclical and unstable character found in an advanced capitalist economy, according to Keynes, can be traced to the instability of investment. Minsky (1975, 61) understood that Keynes believed that the classical theory of equilibrium was not attainable in the way many classical economists had theorized. Keynes thought of long-run equilibrium as a moving target, which if ever achieved, would be for but for a short moment. From

Minsky's (1975, 68) writings we know that in Keynes' view, each short-term equilibrium should be understood as a transitory moment. Keynes's view can be best explained by noting that forces generate a tendency towards equilibrium, but equilibrium is never actually achieved. According to Minsky (1975, 20), Keynes's work quickly caught on and became popular, and many economists welcomed some of his innovations, such as the consumption function, while truncating others, such as uncertainty in decision-making. Minsky's financial instability hypothesis should be seen as an extension of Keynes' efforts to deal with this subject of uncertainty.

Minsky (1975, 66) specifies that many of the economists that interpreted *The General Theory* tended to trivialize Keynes's ideas regarding uncertainty, thereby missing what proves essential for understanding this book. In the views of Keynes and also Minsky, uncertainty proves fundamental to the modern capitalist economy. More specifically, uncertainty appears when cash is transferred from depositors to banks, which then lend to businesspeople undertaking investments. The transfer of cash from one to another is founded upon the expectation that the cash will be returned with repayments of the original principal plus interest. In other words, Minsky (1975, 77) purports that the financial portfolios held by institutions and firms in an advanced capitalist economy are axiomatically speculative in nature. In the capitalist economy, as the businesses purchase capital assets with borrowed cash, the borrowing can be referred to as a "liability", that is, the business becomes indebted and must pay back the original amount at some specified point in the future. Minsky (1975, 89) goes on to explain that managers of the business believe they will be able to fulfill the liability commitment because it is speculating that its investments in capital assets will indeed produce sufficient cash flow to pay off the liability and also produce value in excess of the liability.

The imperative of accounting for uncertainty in economic analysis should be seen as the Keynesian view that Minsky emphasizes. If the speculation of a business materializes, then its stock will appreciate in value and the businesspeople will have achieved their goal of producing excess value. At the aggregate level, the stock markets will appreciate, and businesspeople will continue to play "the mixed game" where skill and luck determine successful speculation. As the market value of businesses continues to rise, bankers will gladly issue more debt because the businesses should be able to fulfill their liability commitments.

It is based upon this Keynesian framework that Hyman Minsky developed his Financial Instability Hypothesis. Without the shoulders of the intellectual giant Keynes to stand upon, it is unclear whether Minsky's financial instability hypothesis would have been presented so brilliantly. Keynes' influence on

Minsky’s thinking is clear and his reliance on Keynes’ writings paved the way for a penetrating understanding of the capitalist economy.

How Crises Unfold

Like Keynes, Minsky believed the modern capitalist, economic system to be inherently unstable. The free-market forces can prove destabilizing by their very nature, and so must be steered, constrained and stabilized, even if for a transient moment. In the modern capitalist economy, government interventions intended to induce stability tend to prove short-lived because the downside protection encourages borrowers and lenders to take on additional risk-taking activities to achieve profits. In *Keynes,* Minsky (1975, 162) explains that as these risk-taking activities produce profits, the margin of safety borrowers and lenders require will decrease, and the entire system will gradually become more risk prone. So, it can be said that crises are formed in an advanced capitalist economy by both inherent flaws in the system in combination with governmental interventions that intend to keep the economy stable.

A crucial piece of the advanced capitalist economy is that it has a sophisticated financial system. The financial system is composed of commercial banks, investment banks, and many other financial intermediaries that mark the capitalist economy (Minsky, 1992, 3). As mentioned in *The Financial Instability Hypothesis*, Minsky (1992, 6) understands that banks are highly leveraged and transfer the cash they receive from their depositors to businesses, with the expectation they will receive a profitable cash flow in the future. Minsky (1986, 229) further clarifies in Chapter 10 of *Stabilizing an Unstable Economy* that the fundamental premise of the business of banking in an advanced capitalist society is the goal of profit maximization.

Reconsidering *Stabilizing an Unstable Economy,* Minsky (1986, 238) explores the idea of bank management motivation. Institutional bank executives are paid mainly in stock options, which can appreciate significantly if the banks share prices increases. So, executives are motivated to increase the market value of their shares because it will make them wealthy. Minsky (1986, 238) states that by emphasizing growth, banks will inherently increase their financial leverage by taking on more debt—which makes the financial system and economy more unstable. These banks, which can be described as economic units, take on risk in the hope of profit. In *The Financial Instability Hypothesis*, Minsky (1992, 6) states that for all economic units, whether firms or individuals, there exist three distinct income-debt relations that explain how financial crises arise. He notes these as hedge, speculative, and Ponzi finance.

Hedge financing units are deemed the safest and most stable among all income-debt relations. Hedge financing units are those whose projected cash flows are expected to cover interest and principle payments on debt. For example, a hedge-financing unit could be observed when a business borrows cash to purchase capital equipment for use in manufacturing, with a strong expectation that the cash flow from the project would indeed prove sufficient to service the debt obligations. In *The Financial Instability Hypothesis*, Minsky (1992, 7) states that the more significant the proportion of equity financing, that is stock financing, in the company's capital structure, the more likely the unit is a hedge financing unit. If all financing units in a capitalist economic system were hedge-financing units, the margin of safety for borrowers and lenders would be relatively high. Minsky (1992, 7) goes on to explain that a high margin of safety with hedge financing units could mean that there is a possibility that the economy would be a self-sustaining and equilibrium seeking system. However, as Minsky and Keynes have pointed out, empirically that such a system is typically not the case.

Instead of an equilibrium seeking and self-containing economic system (as classical economists tout), Minsky (1992, 7) explains that we are more likely to see a "deviation amplifying system"; whereby borrowers and lenders turn to higher-risk activities in search of greater profits. Minsky (1992, 7) terms these as "speculative financing units", and can be defined by their cash flows proving sufficient for covering mandatory interest payments. As explained by Randall Wray (2016, 79) in *Why Minsky Matters,* speculative finance units currently do not produce sufficient cash flows to cover principle payments, but they are expected to rise sufficiently in the future to do so. A riskier profile than hedge-financing units, speculative financing units should be seen as the natural extension of hedge units because the longer the period of stability, the more desperate the economic units seek out profits.

The third and most risky profile of which Minsky warned is Ponzi finance. Minsky (1992, 7) explains that Ponzi financing units are those with cash flows that prove neither sufficient to cover interest payments nor principle. Unless Ponzi units sell their assets or borrow additional capital to sustain themselves, they are unstable and cannot succeed in the long run. Minsky (1992, 7) warns us that an economic unit that adopts the Ponzi financing unit reduces the margin of safety its creditors hold. Again, in *Why Minsky Matters*, Wray (2016, 79) goes further to explains that a Ponzi unit borrows capital to pay its mandatory interest payments.

As described above, hedge financing registers as the only financing unit in which the capitalist economy may be an equilibrium seeking and containing system. Minsky (1992, 7) teaches us that when economic units inevitably leave hedge financing for the two other units (speculative and Ponzi financing), they are likely to make the economy a deviation amplifying system. Minsky (1992, 4) adds that each financing unit may last for a time, but eventually the skill and luck of businesspeople will run out, and their pro forma statements will not materialize. This is the point in time when a crisis occurs. Minsky (1992, 8) stresses that a critical component to understanding the financial instability hypothesis is that the economy is stable under certain financing regimes and unstable under others. Minsky (1992, 8) mentions that another axiom of the financial instability hypothesis is that the capitalist economy will transition to different income-debt relations over periods of prosperity, turning from stable to unstable.

Through real-time, the economy will experience growth and prosperity and this part of the cycle allows businesspeople to profit from their hedge financing units. Minsky (1992, 7) makes it clear: as the good times and profits continue, businesspeople will tend to become bolder and move to speculative units, and eventually, they will succumb to Ponzi finance. Minsky (1992, 8) goes on to teach us that predictably, the low margin of safety offered by Ponzi financing units and the inability to service debt payments with cash flows will cause the businesses to sell their positions, which will collapse asset values and result in a financial crisis.

Minsky on Financial Cycles

Minsky (1992, 1) stresses that his financial instability hypothesis has both empirical and theoretical aspects. As noted above, Keynes' *General Theory* explained that the Great Depression was not the wrongdoing of any specific actors; rather, the deep and enduring downturn was but a reality which sophisticated capitalist economies tend to suffer, though there are mechanisms that can be implemented to lessen the damage. Historical episodes of expansion and contraction**,** which continually occur in modern capitalist economies, are empirical evidence supporting Minsky's hypothesis. The theoretical aspects of the financial instability hypothesis begin with the modern capitalist economy, which has capital assets and a sophisticated financial system ripe with financial intermediaries.

Minsky (1992, 1) states that there are two main periods in a modern capitalist economy: stable periods and unstable periods. When the times are stable, real income tends to be rising, employment increasing, and there is a prevailing sense of general optimism about the economy and future growth. During unstable times, there are painful economic contractions wherein unemployment runs rampant, and there is a negative outlook on the future of the economy. The cyclical nature of the economy supports Minsky's understanding that indeed there is no "invisible hand" as Adam Smith and most modern economists proclaim. Minsky's view is that the dynamics of the capitalist economy prove destabilizing. As Wray

(2016, 16) clearly points out, Minsky's financial instability hypothesis argues that even when times are stable, such stability will encourage risk taking and fiscal and monetary policy tightening, leading to a fragile and unstable economy.

We can understand the financial cycles that Minsky knew to be an innate characteristic of the modern capitalist economy by further examining Minsky's Levy Institute *Working Paper*. On the last page of this paper, Minsky (1992, 8) teaches us that when the central bank uses its monetary policy tools to constrain the money supply, the intervention only encourages more risk-taking behavior and turns formerly speculative finance units into Ponzi units. Then we need to consider that these Ponzi units are even more unstable than the speculative units, and can exacerbate a future recession by collapsing asset values. Minsky understood that stability turns to fragility, time and again, and this tendency proves integral to the normal workings of the capitalist system.

Conclusion

This inquiry has sought to establish that in his *The Financial Instability Hypothesis*, Hyman Minsky considered the forces and variables that induce financial instability. We can see that Minsky thought of financial instability as an feature inherent to the advanced capitalist economy—a sort of unavoidable evil in the system. While this short inquiry has not meant to offer an all-encompassing analysis of the sources that might cause financial instability in the advanced capitalist economy, it is sufficient to understand the forces and variables that Minsky discussed in *The Financial Instability Hypothesis*. During times of prosperity, economic units see great profits and success with comfortable margins of safety through using hedging units, prompting them to take on additional risk. Interventions by the federal government might also contribute to the risk-taking behavior of economic units by limiting the downsides through protections. The hedge units' transition to riskier speculative units which then graduate to unstable and very risky Ponzi units.

A question to ponder upon reading this inquiry is "What do we all make of this?" Should the people accept that our current system will have good times and bad times, with increasingly painful bad times and shorter good times, or should we do something to change the system? After all, the capitalist system has had a long run in the United States and in other countries, yet the neo-classical economists continue to affirm that the free-market system will correct itself. In *Stabilizing an Unstable Economy*, Minsky (1986, 287) explains that it appears current leaders and advisers in modern capitalist economies do not seem to be aware that the day-to-day functioning of the economy leads to financial crises and all sorts of economic woes. Perhaps there is a need for a new system, or a hefty reform of the modern capitalist system that Minsky has clearly shown tends towards fragility and instability.

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