

Rules, instability and crisis

ALESSANDRO RONCAGLIA *

1. Introduction

This special issue of the *PSL Quarterly Review* includes some articles which appeared over the years in the first series of our journal (then entitled *BNL Quarterly Review*: see Roncaglia, 2008). The articles published below have been selected among those that can help us to best understand the roots of the current economic crisis and the problems that may compromise our efforts to overcome it, or even worse, may generate yet further difficulties. Our journal is starting a new life, as from 2010 returning to its old quarterly schedule. With this special issue, we wish to illustrate certain aspects of its traditional approach that we mean to retain in the new series. We may summarize these aspects under four broad headings: openness to different approaches in the field of economics; the importance attributed to cooperation between economic theory, history, analysis of institutions and statistical investigation, for a better understanding of real-world issues; the importance – even if not exclusive – attributed to monetary and financial issues and to international economic issues; and, last but not least, the tenet that economic investigation should aim at interpreting the real world, that it should not turn into a speculative game as an end in itself, or be taken as a foundation to build an academic career.

In selecting articles for publication, our journal has systematically attached importance to such aspects. It is precisely for this reason that a retrospective view of how our journal dealt with themes more or less directly connected to the background of the present financial and economic crisis may prove for us a cause of legitimate satisfaction.

* Dipartimento di Studi Sociali, Economici, Attuariali e Demografici, Sapienza Università di Roma, e Associazione Paolo Sylos Labini. E-mail: alessandro.roncaglia@uniroma1.it

Growing instability in capital flows, the failure of monetary policy to take steps to control speculative bubbles in the prices of financial and housing assets, distortions in the banking and financial system regulatory framework and the limits of prudential surveillance, macroeconomic disequilibria in the USA and the international economy: all these elements came under focus and analysis in the articles included in this special issue, and indeed in many other contributions published in the first series of our journal and/or its Italian cousin, *Moneta e Credito*. (The parallel special issue of *Moneta e Credito* includes articles on the same topics that appeared in Italian in that journal; thus, it does not completely coincide with the choice of articles published here.)

Obviously, in accordance with the first of the four criteria recalled above, namely openness to different approaches in the economics field, the contributions published below differ not only in terms of the themes dealt with, but also in the analytical approach adopted in each case. In various instances the analytical approach proves ‘heterodox’, in contrast with the now prevailing mainstream: but not in all instances, and in ways and in degrees differing from one article to another. In this respect, before surveying the articles published below, it is worth taking a look at the theoretical contributions of an economist, Hyman Minsky, often cited in the debate following upon the outbreak of the financial crisis, but previously ignored by mainstream contemporary economists. He was considered – and with good reason – to hold views quite different from those characterizing mainstream neoclassical economics. Even when they are not directly recalled in the articles included in this special issue of our journal, Minsky’s theories constitute in any case a point of reference and comparison which may help the reader to appreciate the variety of approaches present in the current debate on the interpretation of the financial and economic crisis affecting the world economy, and to locate the articles published below in the context of the debate. Let us recall, for instance, that the author of two of these articles, Kindleberger, utilized Minsky’s theories as interpretative key for his celebrated history of crises (Kindleberger, 1978).

2. Minsky's contribution

It is difficult to sum up Minsky's theoretical approach in a few words. Let us try to characterize its main elements, consisting in a theory of financial fragility, a theory of crises and a theory of the evolution of capitalism.¹ As a premise, note that these contributions are grounded on a Keynesian approach which differs both from the mainstream interpretation of Keynes that had long dominated in macroeconomic textbooks and teaching (the IS-LM schedules of the Hicksian model developed by Hicks, 1937) and from the tradition of Keynes's immediate pupils in Cambridge (illustrated for instance in Joan Robinson's writings). As a matter of fact, Minsky's first major work was devoted to this interpretation of Keynes's thought (Minsky, 1975), and these theoretical foundations should be borne in mind up on approaching his subsequent writings (in particular the essays collected in Minsky, 1982), which we shall now go on to consider.

The financial fragility theory stems from the distinction between three different kinds of budgetary positions. At one extreme we have the case of a "covered" position, when the economic agent runs into debt in order to acquire a real or a financial asset, but his/her cash flow is (or is expected with confidence to be) greater, in each interval of time, than the instalments for interest and debt amortization. The difference between the two flows – expected income and repayment instalments – constitutes a safety margin vis-à-vis potential changes in the situation (e.g. a fall of the flow up income, or a rise in interest rates in the case of a variable-rate debt).

When the safety margins are reduced, or when from the very outset the economic agent foresees the possibility of having to re-finance the debt – or, more commonly, part of it – before full repayment, we are confronted with a speculative position. In this case, if for a certain span of time the income flow turns out to be temporarily insufficient to pay the instalments of debt amortization, the value of the assets acquired thanks to the loan (for instance, plant and machinery for manufacturing firms, or

¹ What follows is illustrated in greater detail in Roncaglia (2010).

bills and bonds for financial firms) can be utilized as a guarantee for bridge financing, and eventually the debt can be fully reimbursed. The speculative nature of this position is connected to the presence of two different kinds of risk: first, that when the time comes round for further financing – in the periods, that is, (foreseen from the beginning) when income flows come below repayment flows – the new debt may prove too costly relative to current income flows or impossible to obtain (liquidity risk); second, that the market value of the collateral assets might show a negative trend (market risk).

At the other extreme we have what Minsky calls “Ponzi finance,” from the name of a famous robber-banker of the beginning of the twentieth century. In this case, the asset acquired by taking on a debt position does not generate an income flow; however, the agent foresees that the market value of the asset will increase in time, in a measure more than sufficient to cover amortization and interest costs on the debt. Hence, the debt needs to be continuously refinanced, and by increasing amounts, because interests cumulate over time. In the end, when the asset is sold at the new, higher price, all debts can be repaid, including those incurred for interest payments. However, if the market value of the asset acquired through debt decreases instead of increasing (or if it increases but not at a sufficient rate, the rate of increase being lower than the rate of interest on the debt), then the agent encounters liquidity problems even before coming up against a solvability problem.

The state of the financial system as a whole depends on the proportion of the different kinds of financial operations. It is safer when covered positions dominate, less solid when speculative positions acquire importance, and decidedly fragile when “Ponzi” positions become a large fraction of the whole.

Minsky’s theory of crises is based on the characterization of financial fragility illustrated above. On it Minsky grounds a fully plausible deductive chain. Speculators (including “Ponzi” speculators) have always existed and always will: they become dangerous when their activities expand beyond measure. Responsibility for excessive financial fragility of the economy is hence to be sought elsewhere. In

fact, it is above all the financial institutions that determine the extent to which the speculators' demand for financing be met, and it is the regulatory framework in which the financial markets operate that sets limits to the actions of the financial operators.

In taking their decisions, financial operators are driven by two opposed pressures. On the one hand, the more they lend the greater are their income flows and, if they accept to take on greater risks, they can be rewarded with correspondingly higher interest margins. On the other hand, they naturally prefer to avoid such hazardous risks that might land them in bankruptcy. Hence, much depends on their evaluation of the economic prospects, which should be evaluated over a long period perspective, looking further than the individual operation under consideration. However, such evaluations depend on the economic climate in which they are made, with a sort of herd behavior reinforced by the very short period viewpoint of the media – newspapers and television. Thus, in good times the managers of financial institutions wax increasingly optimistic and tend to attribute ever less importance to risks, over-evaluating the existing margins of safety.

This is also the case when financial institutions utilize the much celebrated models for risk evaluation, since these models – apart from discarding by assumption the possibility of structural changes in the economy – utilize finite data series – in general not very long – occasionally with decreasing weights for the older data. Moreover, the context of motivations which govern financial agents in their choices – competition from other agents, the structure of incentives commonly utilized in the financial sector in order to determine manager compensation at the higher levels – implies that agents focus on immediate outcomes, losing sight of the “context” risks, like problems of liquidity or crises of confidence sweeping through the whole economy, in “normal” times considered highly unlikely or of no immediate concern. Hence, not only are the safety margins required on loans gradually reduced, but, more importantly, the proportions of the different kinds of financial positions change, in the direction of greater fragility for the economy. Thus, as soon as the economic

climate changes and storm clouds gather, after a sufficiently long period of good weather, crisis can break out with unexpected violence. Usually, the first sign of such crisis is a wave of bankruptcies, hitting hardest the agents who had taken on greater liquidity and market risks. According to Minsky, the immediate origin of the wave of bankruptcies may lie in an increase in interest rates, sooner or later induced by increasing inflation.

When confronted with financial crisis, the authorities responsible for policy intervene in the attempt to limit its effects. This implies, crisis after crisis, rescue of financial institutions on the verge of bankruptcy to curb the risk of contagion within the financial sector. Market operators incorporate such policy choices on the part of the financial authorities in their expectations and so, crisis after crisis, tend to accept ever greater risks. As a consequence, the risks wittingly incurred by the financial institutions increase, and the potential (and actual) proportions of the crises grow with the passage of time.

Finally, Minsky characterizes the development of capitalism as a sequence of stages showing markedly different characteristics: the entrepreneurial capitalism of the origins is followed by the managerial capitalism in which the big corporations dominate, and finally, in the most recent stage, by the money managers' capitalism, in which finance dominates the economy and is characterized by a very short perspective in decision-taking, in contrast with the perspective taken by entrepreneurs and manufacturing managers, focusing on the long period evolution of production techniques and markets. The increasing role of finance in the economy is thus seen as a profound change in the nature of capitalism, and not simply in terms of the growing importance of a specific sector within the economy.² Minsky, we may add, considered this evolution not as progress, but (following in the footsteps of Keynes, who was clearly hostile to an excessive role of

² Analogously, the French "regulation" school posits accumulation led by finance as a specific "regime." Cf. for instance Boyer (2009).

finance in the economy) as a negative factor, to be checked through the development of a well-designed regulatory framework.³

3. The contents of the present issue

The brief illustration of Minsky's views may be useful, as suggested above, for a better understanding of some distinctive characteristics of the contributions proposed anew in this special issue of our journal.

The first of the two papers by Kindleberger focuses on comparison between the Great Crisis of the Thirties in the last century and the crisis which followed upon the stock exchange crash of 1987. Kindleberger explicitly states the use he makes of Minsky's theories as an interpretative key in this comparison; actually, however, he ranges over a variety of aspects to establish clearly, in the light of analogies and differences between the two episodes, the elements of fragility already present in the US economy more than twenty years ago.

Kindleberger's second article also takes reference from the vicissitudes and policy debate of the times of the Great Crisis to stress the risks intrinsic to sharp increases in the prices of financial assets, attributed to deregulation and financial innovation. Kindleberger maintains that monetary policy should include among its targets control over asset inflation – that is, increases in the prices of financial assets, housing and natural resources – in view of the risks which may stem from this kind of inflation, first of potential financial crises, and subsequently of wide-ranging economic crises.

Kindleberger's stance may be appreciated precisely in the light of Minsky's analysis. As we have seen, Minsky's theory stresses the potentiality of crises on an ever vaster scale unless the monetary authorities do something to check the trend towards increasing fragility of the financial system. The interpretation of Keynesian theory proposed by

³ "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." Keynes (1936), p. 159.

Minsky stresses the distinction between the demand for money for transaction purposes (which mainly concerns the current flows of production and exchange) and the demand for money for speculative purposes (which has mainly to do with assets), and just how much higher the latter kind of demand is than the former. The idea that monetary policy should choose, as its main target, asset inflation is also connected to rejection of the quantity theory of money, and to adoption of a theory of interest as the price of liquidity (which constitutes an insurance against uncertainty).

Volcker, Governor of the Federal Reserve before Greenspan, has a more traditional background but is also, as a man of institutions outside the academic world, less constrained by orthodox views – a conscious pragmatist. In comparison to Greenspan's extreme free market attitudes, we also note the greater importance attributed to market regulations (recently stressed by Volcker in US Congressional hearings). Recalling that it was Volcker who had previously (at the beginning of his tenure as Governor) enacted the transition from a monetary policy focused on control of interest rates to a policy focused on control of monetary supply – along lines that had been theorized by Friedman – we may perhaps see in the position he assumed at the end of the Nineties the fruit of experience, and specifically his ex post recognition of the instability which the new monetarist policies had entailed – instability which gathers momentum in the presence of a high monetary lever. However, instability is not considered by Volcker as endogenous to market economies, but attributed to (unavoidable) mistakes in the conduct of economic policy; in his words, “If reasonable stability in world exchange and financial policies must rest upon error-free policies, a high degree of volatility is inevitable.”

With the articles by Sylos Labini, Godley, Godley and Izurieta, we enter directly into the field of Keynesian macroeconomics. All three contributions stress the macroeconomic disequilibria of the US economy: deficit in the balance of payments and deficit in the private sector account, as counterpart to an increase in the monetary base. All three contributions stress that disequilibria in the accounts of the main macroeconomic sectors translate into tensions over the stocks of internal

and external debt. Godley, and Godley with Izurieta, show that the resulting macroeconomic situation cannot be sustained for an indefinite time; relatively wide disequilibria in macroeconomic flows cannot persist for long without generating an excessive growth in the dimensions of the stock of debt, so that any spark may trigger explosion of a world-wide financial and economic crisis. Sylos Labini also stresses the increasing inequalities in the distribution of income, and the rise of a speculative bubble in the housing market. His clear-cut views deserve recalling: in his opinion, the situation at the beginning of the third millennium is similar in many important respects to the state of affairs prevailing in the 1920s; hence the “serious worries about the American economy, which strongly conditions the economies of the other countries.” Sylos Labini also stresses that in both cases the risk of a crisis arises in connection to a previous wave of innovations.

This latter, typically Schumpeterian, element is the object of another article, by Reati and Toporowsky, included in our special issue. After illustrating the theory of technological long waves, the paper focuses on their policy implications, noting among other things that “to re-establish the primacy of productive capital [...] systematic concerted open market operations to regulate liquidity in financial markets” are required.

Tonveronachi’s two contributions concern the regulation of banks, and analyze the biases of the approach on which the Basel agreements rely. According to Tonveronachi, the methodological individualism embedded in the mainstream marginalist approach conditions the approach to risks adopted in the Basel regulatory framework. Indeed, what happens in the aggregate is viewed as the simple adding-up of the choices of individual operators: a view clearly opposed to the Keynesian one, where aggregate analysis has a value in itself, independent of, if not prior to, micro analysis. As a consequence, systemic risk is conceived, within the Basel framework, as the sum of individual risks. This view is once again implicit in the identification of the systemic stability issue with the existence of banks – or financial operators in general – “too big to fail.” What is ignored here is the importance of phase correlations connected to contagion phenomena and to the influence of the general climate of expectations on entrepreneurial decisions. In addition, the

regulatory system actually in place favors large banks more than small and medium concerns. At the world level, and particularly as far as internal financial fragility and external debt of developing countries are concerned, risks are also aggravated through the tendency to attribute the International Monetary Fund and the World Bank with increasingly marginal roles.

Finally, Minsky's autobiographical essay is re-proposed as a tribute to the economist who made a particularly original contribution to our understanding of the endogenous tendency to financial crises embedded in the dominance of finance within contemporary capitalism: what Minsky calls money managers' capitalism. Minsky's inclusion in the group of eminent economists selected for the series of Recollections articles, published in the old series of our journal notwithstanding his relative isolation in the US academic world, concretely shows, we may add, the openness of our journal to nonconventional but theoretically solid and empirically well founded approaches which, as we have sought to illustrate in this brief introduction, can contribute in various ways to our understanding of current economic events. Obviously each reader will be able to form his or her own opinion on the usefulness of different approaches to economic analysis; in any case, perusal of the articles collected in this special issue of our journal may contribute to a more considered evaluation of the economic debates currently under way.

REFERENCES

- BOYER R. (2009), "Feu le régime d'accumulation tiré par la finance," *Revue de la régulation*, n. 5, <http://regulation.revues.org/index7367.html>.
- GODLEY W. and IZURIETA A. (2009), "The US economy: weaknesses of the 'strong' recovery", *PSL Quarterly Review*, vol.62, pp. 248-251.
- HICKS J. (1937), "Mr. Keynes and the classics: a suggested interpretation" *Econometrica*, vol. 5, pp. 147-59.
- KEYNES J.M. (1936), *The General Theory of Employment, Interest and Money*, Macmillan, London; rist. in J.M. Keynes, *Collected writings*, vol. 7, Macmillan, London 1973.
- KINDLEBERGER C.P. (2009), "Asset inflation and monetary policy" *PSL Quarterly Review*, vol. 62, pp. 248-251.
- KINDLEBERGER C.P. (2009), "The 1930s and the 1980s: Parallels and Differences" *PSL Quarterly Review*, vol. 62, pp. 248-251.

- KINDLEBERGER C.P. (1978), *Manias, Panics and Crashes. A History of Financial Crisis*, New York, Basic Books.
- MINSKY H.P. (2009), "Beginnings", *PSL Quarterly Review*, vol. 62, pp. 248-251.
- MINSKY H.P. (1975), *John Maynard Keynes*, New York, Columbia University Press.
- MINSKY H.P. (1982), *Can 'it' happen again? Essays on instability and finance*, (N.Y), Sharpe, Armonk.
- REATI A. and TOPOROWSKI J. (2009), "An economic policy for the fifth long wave," *PSL Quarterly Review*, vol. 62, pp. 248-251.
- RONCAGLIA A. (2010), *Economisti che sbagliano*, Roma-Bari, Laterza.
- TONVERONACHI M. (2009), "Structural biases in prudential regulation of banks," *PSL Quarterly Review*, vol. 62, pp. 248-251.
- TONVERONACHI M. (2009), "Implications of Basel II for financial stability. Clouds are darker for developing countries," *PSL Quarterly Review*, vol. 62, pp. 248-251.
- VOLCKER P.A. (2009), "Globalization, Stability and the Financial Markets," *PSL Quarterly Review*, vol. 62, pp. 248-251.