BEHIND THE NUMBERS
economic facts, figures and analysis

CCPA
CANADIAN CENTRE
for POLICY ALTERNATIVES
CENTRE CANADIEN
de POLITIQUES ALTERNATIVES

April 2010

The Global Financial Meltdown
Can We Avoid Another Minsky Moment?

By Arthur Donner and Doug Peters

"Twenty-five years ago, when most economists were extolling the virtues of financial deregulation and innovation, a maverick named Hyman P. Minsky maintained a more negative view of Wall Street; in fact, he noted that bankers, traders, and other financiers periodically played the role of arsonists, setting the entire economy ablaze. Wall Street encouraged businesses and individuals to take on too much risk, he believed, generating ruinous boom-and-bust cycles. The only way to break this pattern was for the government to step in and regulate the moneymen."

— John Cassidy, The Minsky Moment, The New Yorker, Feb. 4, 2008

The financial crisis which began in 2007 is still not completely over. A key ingredient was the global housing market bubble, which peaked in the U.S. in 2006 and then collapsed in 2007. That bubble was related to a notable lapse in regulation and a lack of common sense in lending. The result was that the values of securities tied to real estate plummeted, damaging financial institutions globally.

Although there were many more complex financial linkages at work, the resulting collapse of liquidity in the U.S. banking system froze the commercial paper and mortgage-backed securities markets, resulting in the collapse of a number of large financial institutions. What followed was a controversial but essential "bailout" of banks by national governments, and downturns in stock markets around the world.

For a while, in 2008 and 2009, the economies of the advanced world were in a free fall, and many economists were worried that a new global Depression was inevitable. Indeed, the recent financial crisis was the worst world-wide economic downturn since the Great Depression of the 1930s.

Hyman Minsky was an American economist whose professional reputation was built by explaining the financial underpinnnings of the business cycle. Throughout his career, Minsky was known as a pessimist and contrarian for advancing the view that long stretches of good times inevitably end in larger financial collapses. His basic proposition, which we enthusiastically endorse, is that financial markets are inherently unstable, a viewpoint he developed in his famous financial instability hypothesis.

When he first advanced this hypothesis in the 1960s, many of his colleagues regarded it as unorthodox, and certainly outside of the mainstream. Now, however, his views of financial instability are becoming mainstream.

One important element in his theory, which others have labelled "the Minsky moment," is especially apt in diagnosing what went wrong with the British, American, and European credit markets after 2003. (The term "Minsky moment" was originally coined by

Paul McCulley of PIMCO in 1998, to describe the 1998 Russian financial crisis.)

In some respects, the financial instability hypothesis seems deceptively simple. In good times investors, banks, and other lending institutions are willing to take on more risk and leverage to enhance their returns. The longer the times stay good, the more risk they take on, until they've taken on too much risk. Eventually, lenders and borrowers reach a point where their cash flow available is no longer sufficient to pay off the mountains of debt they have acquired. Losses on speculative assets backed by loans prompt lenders to call in their loans—and, as prices of the speculative assets fall, borrowers find themselves unable to repay their loans.

The Minsky moment occurs when institutions and individuals are forced to sell off their speculative asset purchases, usually at a great discount from the original purchase price. This course of action, often called "de-leveraging" by financial analysts, is unpleasant, since the assets-sellers *must* sell; they have no choice.

As John Cassidy explains it, there were basically five phases in the Minsky financial instability hypothesis leading up to the credit cycle collapse: displacement, boom, euphoria, profit-taking, and panic.

It is rather remarkable how closely the recent U.S. and European financial markets experience followed all five stages of the credit cycle into the inevitable collapse.

The displacement phase occurs when investors get excited about virtually anything, and in the early years of this decade an unusually easy Federal Reserve policy helped create excitement around the growth in the U.S. economy. That is, in 2003 the Fed, led by former chairman Alan Greenspan, reduced short-term interest rates to one per cent, and there was an unexpected influx of foreign money, particularly Chinese money, into U.S. Treasury bonds.

The boom phase of the credit cycle can be traced to the speculative real-estate bubble which quickly developed, and which dwarfed in magnitude the earlier bubble in technology stocks.

The profit-taking phase of the cycle began around 2004 and ended with the collapse of Lehman Brothers in September 2008.

The euphoria stage was characterized by over-exuberance and lack of rational lending policies by lenders and banks. Loans were extended to dubious financial borrowers and institutions, and there was the creation of exotic, new financial instruments to support the over-leveraging of financial balance sheets.

In the 1980s, junk bonds were at the centre of the euphoria phase, and in recent years this phase was characterized by the massive expansion of sub-prime mortgage debt and the securitization of these mortgages. Securitization allowed U.S. banks to sell off their dubious mortgages without ever worrying about eventual repayment. In other words, the final holders of the mortgage debt were so far removed from the borrowers that no one was concerned or even able to calculate the true level of the risks being taken.

The panic stage, which occurred only two years ago, was associated with the Bear Stearns bailout, the U.S. government takeover of Fannie Mae and Freddie Mac, the Lehman Bothers bankruptcy, the sale of Merril Lynch & Company, and the massive infusion of federal funds into AIG, all of which created a financial atmosphere verging on panic.

Indeed, in the last panic phase, the bankruptcy of Lehman Brothers resulted in the takedown of a great financial institution that survived the stock market crash of 1929. Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15, 2008. The Dow Jones closed down just over 500 points (-4.4%) on September 15, 2008, at the time the largest one-day drop by points since the 9/11 attack. This drop was subsequently exceeded by an even larger 7% decline on September 29, 2008.

Thankfully, financial markets are now in recovery, due in no small part to the fact that massive amounts of private debt have been assumed by the public sector. There have also been significant write-offs of debt by financial institutions, leaving many of those institutions in need of additional capital. The institutions that are left have retrenched on their risk-taking to such an extent that recovery of the whole economy is being hampered. There has also been a large infusion of public sector spending, all very needed to avoid a much deeper recession.

What one hears now from many important financial commentators is an out-of-context concern about the

size and extent of public sector debt. Their real priority should be to get the private sector investing again so as reduce unemployment and to get the world economies growing at a substantial pace.

Lenders and borrowers, who have seen the edge of the credit abyss close up, now need to re-assess their risk standards and move to some reasonable assessment of both borrowers' needs and lenders' risk capacities.

The recent exaggerated concerns over government debt and deficits are neither well understood, nor for the most part even rational. It should be understood that, despite signs of a global recovery, it is government spending that is keeping the major economies from falling back into recession. Only when the private sector takes on the task of investing again and creating jobs can the public sector debt and deficits be reduced.

In this uncertain and fragile recovery stage, it is also necessary to rethink the regulatory environment that allowed the Minsky moment to occur in the first place. New regulation of banking and credit markets are currently being considered in the advanced economies.

It is especially important that the financial markets in the United States be seen to develop a new mode of regulation that will make a Minsky moment an historical anomaly.

(*Arthur Donner is an economic consultant in Toronto. Doug Peters is a former chief economist of the Toronto-Dominion Bank.)*

national office • bureau national • 410—75 rue Albert Street • Ottawa, ON K1P 5E7
tel: 613-563-1341 • fax: 613-233-1458 • info@policyalternatives.ca • www.policyalternatives.ca

CAW 567 OTTAWA