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PREVENTING THE LAST CRISIS: MINSKY'S FORGOTTEN LESSONS TEN YEARS AFTER LEHMAN

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The 10th anniversary of the September collapse of the US financial system has led to a number of commentaries on the causes of the Lehman Brothers bankruptcy and cures for its aftermath. Most tend to focus on identifying the proximate causes of the crisis in an attempt to assess the adequacy of the regulations put in place to prevent a repetition. It is interesting that while Hyman Minsky's work became a touchstone of attempts to analyze the crisis as it was occurring, his work is notably absent in the current discussions.

While it is impossible to discern how Minsky might have answered these questions, his work does provide an indication of his likely responses. That is, returning to Minsky allows us to see that dwelling on the proximate causes of the last crisis and the details of the 2010 Dodd-Frank reforms misses a more pressing point. Although Minsky himself had outlined an account of what a successful restructuring of the financial system might look like (Levy Institute 2012; Kregel 2014), his analysis of capitalist finance in general and the evolution of that system since the 1980s in particular contains a broader lesson: that crisis and instability are nevertheless inherent to the system. In addition to being wary of persistent appeals to deregulation, a central part of this decennial debate

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should focus on shoring up those government institutions that can prevent financial fragility from turning into a prolonged crisis in the real economy—institutions that have been badly undermined over the last several decades.

Those familiar with Minsky's work will recall his emphasis on the endogenous generation of fragility in the financial system, a process building up over time as borrowers and lenders use positive outcomes to increase their confidence in expectations of future success. The result is a slow erosion of the buffers available to cushion the inevitable disappointment when those overconfident expectations are not met—and the disappointment is inevitable, for as Minsky argued, the confirmation of expectations of future results depends on decisions that will only be taken in the future. Since these decisions cannot be known with certainty, today's expectations are extremely unlikely to be fully validated by future events. In a capitalist economy, financial commitments are financed by incurring debt, so unmet expectations will produce a failure to validate debt, leading to the inexorable transformation of financial positions from what Minsky called "hedge" to "speculative," and then to "Ponzi" financing structures. These structures refer to the ability of current cash flows to meet these commitments.

Thus, for Minsky, the crisis that broke out 10 years ago would have been considered the culmination of a process that started much earlier, sometime in the 1980s. An important aspect of this process was the attack on the role of government and support for more restrictive fiscal policies that followed President Reagan's pronouncement in his first inaugural address that "government is not the solution to our problem; government is the problem," producing more procyclical budget policy that removed what Minsky described as the "Big Government" floor under incomes during a recession. For Minsky, the sign of the budget was not important, but its role as an automatic stabilizer was crucial to financial stability (Minsky 1995). At the same time, the rise of monetarist monetary policies meant the "Big Bank"—the Federal Reserve (Minsky 1985)—was no longer assured of placing a floor under asset prices by acting as a lender of last resort. By the early 1990s, Minsky had thus reversed his belief that a repetition of the Great Depression was unlikely because of the role of the Big Government and the Big Bank. Both had been diminished to the extent that they were no longer able to counter the inevitable translation of fragility into instability. By the 1990s, he clearly believed "it"—a Great Depression–type event—could happen again.

Another part of this reduction of the role of government involved the push for deregulation of the financial system. Minsky's view of the operation of the financial system was couched in the recognition that banks are profit-maximizing enterprises, just like any other capitalist firm, and their pursuit of profit is an important source of the endogenous decline in the cushions of safety that leads to financial instability. But Minsky understood, as did Joseph Schumpeter, that banks create their profits in a different way from other business firms. There is no limit on the ability of banks to finance investment positions, because banks can "create money out of nothing." Since there is no financing constraint for banks as a whole, the pursuit of profit is little constrained by rising costs (largely determined by the need to prevent deposit drain due to competition from other banks). Profit maximization for the system as a whole thus leads to maximizing loan volume. In this view of the operation of the financial system, it is the role of bank regulations to put a cap on volume: prudential regulations are meant to make the system safe, but they also place a constraint on bank profitability. Banks are thus ever led to expand into new activities and innovate new mechanisms of liquidity creation to circumvent bank regulation.

One of the main elements of the success of the New Deal banking legislation was the monopoly given to commercial banks to fund investments with liquidity generated through deposit creation. This regulation is often presented as providing banks with zero-cost funding (they already had the ability to create money out of nothing), but what was important was that it provided protection against competition and a kind of guarantee on commercial bank profits, thereby dampening the importance of innovation. But Regulation Q proved to be its own undoing, as policy rates increased with the implementation of tighter monetary policies and large corporations increasingly moved their cash management and financing business away from regulated commercial banks and eventually into the arms of investment banks—the latter providing innovations that competed with bank deposits but escaped regulation.

As the share of financial assets on commercial banks' balance sheets declined, so did their profitability, pushing them to seek innovations on the liability side of their balance sheets to offset the decline in their asset earnings. With the reappearance of the chorus announcing the demise of commercial banking (it had initially appeared in the late 1920s, as corporations shifted from bank funding to cheaper equity issuance in a booming market) joined by free market economists arguing against the deposit monopoly, Congress was led to initiate an era of deregulation based on the pretext of saving the commercial banks from disintermediation.

The perceived need to support banks' profits led to the paradox of regulators willing to deregulate and sacrifice stability in order to restore bank profitability. It is not necessary to rehearse the experience of the savings and loan crisis, or the 1980s commercial real estate crisis, to see this process at work. To understand the culmination of the process of deregulation in the 1999 financial reforms and the genesis of September 2008, it is sufficient to recognize that bank regulations are written to support bank profits. The subprime mortgage crisis was thus a relatively small bump on the inevitable path to crisis.

There is a second element in this endogenous process of fragility, better represented by two prior anniversaries: the Long-Term Capital Management (LTCM) crisis of 20 years ago, which was itself an echo of the junk bond crisis 10 years before that. Michael Milken's Drexel Burnham junk bond financing unit created an unlimited source of liquidity for what was euphemistically called "value extraction" by corporate raiders: to finance the arbitrage buying and selling of whole companies. In Minsky's initial writing, the emergence of instability came from the financing decisions of business firms engaging with bankers to finance productive investments (Minsky 1964, 1972). The key to stability was the generation of income from those investments sufficient to meet the financial commitments. But Milken substituted whole companies for individual investment projects, and the validation of the financing was generated by manipulating the company's financial operations to increase leverage and then reissue equity to sell the company at a profit. Capital gains replaced income as the source of validation, while the companies ended up holding the increased debt—an endogenous process of increasing financial fragility in the business sector at the expense of shareholders.

LTCM represented the crisis of modern finance in embryo—the Lehman of its time. A financial institution born of the combination of high mathematical finance and high-speed computing capacity, it specialized in relative value trades—not of companies but of financial asset positions—arbitraging small mispricing of financial instruments due to market imperfections of various sorts. These small basis-point differences could only be exploited by high-volume borrowing to combine offsetting short and long positions that would contractually converge to produce sure (ignoring counterparty risk) profit. LTCM thus provides a variant of the shift of financial institutions from providing funding for investment in productive activities (with the validation of the loans depending on income flows) to providing funding for investments validated solely by the evolution of prices determined by the investment decisions of other investment institutions (what is now called "proprietary trading," and which depends on increasing volume to increase profits). This is the origin of Minsky's "money manager capitalism," in which the validation of debt by means of income generation from the market success of an investment is replaced by the validation of debt by the capital gains generated from predictions of future asset prices. Indeed, the downfall of LTCM, aside from the collapse of the liquidity it required to hold its relative value positions, was caused by venturing into more purely speculative equity and other positions in which there was no contractual future market price.

The impact of these two factors became visible in banks' earnings statements starting in the 1980s, illustrated by the decline of net interest income and the increase in proprietary trading income and the fees and commission income from advisory and wealth management. We could say that net interest income is a fossil of the Glass-Steagall regulatory system, while proprietary trading income reflects the new regulatory system that came to dominance in the 2000s. The system was transformed from one in which productivity gains produced the income to validate debt to one in which innovation increased liquidity sufficiently to drive up asset prices to generate capital gains income. But while productivity gains are self-validating in an expanding economy, increasing liquidity to produce capital gains eventually falters on the inevitable disappointment set up by overconfident expectations. And the system becomes more fragile and more crisis prone.

In one of his early papers, Minsky produced a very simple formula for bank profitability as the result of the returns on its asset positions and balance sheet leverage (Minsky 1977). The current system can be read as a substitution of productivity gains as the driver of asset returns with arbitrage or capital gains as the driver of asset returns under money manager capitalism. Innovation in liquidity creation driven by regulation thus provides the higher leverage that supercharges asset returns. The evolution of the system has thus influenced both elements determining bank returns: toward increased fragility and dependence on movements in asset prices (rather than movements in income flows) to validate debt. The major postcrisis regulatory changes—increasing capital and liquidity ratios—have a dual, contrasting impact on fragility. Higher capital ratios match the higher risk and volatility of asset returns based on market price appreciation, but they also increase costs and create an incentive to increase leverage and undertake regulatory innovation.

At the 27th Annual Hyman P. Minsky Conference held recently at the Levy Institute, Frank Veneroso (2018) noted two anomalies of the impact of money manager finance in the current system. The first is the substantial rise in the ratio of nonfinancial corporate debt to GDP in the presence of large corporate cash accumulations and the highest corporate profit rates since the 1920s. The second is the large number of public corporations (one-third to one-half) with zero net income in the presence of historically high equity market multiples and negative interest coverage ratios in the presence of historically low interest rates. Veneroso makes the case that the corporate debt figures are understated, while the corporate profit figures are overstated. At the same conference, Robert McCauley (2018) presented similar figures for European and emerging market companies. One obvious explanation of this paradox is that the debt cannot be validated by income but will require increasing asset prices, which can only occur with higher liquidity creation and financing—what Minsky would have called a Ponzi scheme. It also seems clear that a return to more normal interest rate policies would worsen debt coverage ratios and call into question the ability of equity markets to continue their historic bull market. While structured subprime securities have disappeared from the financial landscape, the modus operandi of the financial institutions—now populated by even larger "too big to fail" banks—seems to have changed little from that which led to the crisis in 2008.

For Minsky, financial fragility is a never-ending story. We cannot eliminate it, we can only attempt to understand it—and resist calls to save the system by relaxing regulation. This is why the Big Government and the Big Bank were the most important bulwarks against the inherent instability of the financial system and the certainty that there will always be another crisis, since they provide automatic, system-wide buffers. Since crisis is inherent in the system, seeking the idiosyncratic causes of the last crisis and assessing the regulations introduced to prevent its recurrence are largely irrelevant. The important point is to understand Minsky's basic contribution: that crisis is inherent to capitalist finance.

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