Modern finance: current crisis and policy debates I

Gary Dymski
Professor of Applied Economics
Leeds University Business School
Email: g.dymski@leeds.ac.uk

Bengaluru Winter School, Bengaluru, India
23-24 December 2015

Map of topics

1. "Classical" vs. Keynesian macro logics
2. Bretton Woods system - Financial stability without globally-induced macro stimulus
3. Financial markets and large banks: escape from regulation, phase 1
4. Hyman Minsky's financial instability hypothesis:
5. After the breakdown of Bretton Woods – a cold plunge into the Neoliberal era
6. Minsky's theory of crisis and crisis resolution in historical context //
7. Financial crisis in the global South: Orthodox and heterodox explanations
8. The Neoliberal overseas lending/crisis cycle
9. Power in Finance 1: Hegemonic power and TBTF //
10. The Subprime Crisis: From financial exclusion to predatory inclusion
11. Power in Finance 2: Financial exploitation and access to credit
12. Post-crisis pressures, debate, and reform efforts //
13. Impacts of the global financial crisis on economies in development
14. Shadow banking: escape from regulation, phase 2
15. Power in Finance: Challenges of global regulation
16. Financial regulation

Map of topics

1. **"Classical" vs. Keynesian macro logics**
2. **Bretton Woods system - Financial stability without globally-induced macro stimulus**
3. **Financial markets and large banks: escape from regulation, phase 1**
4. **Hyman Minsky's financial instability hypothesis:**
5. **After the breakdown of Bretton Woods – a cold plunge into the Neoliberal era**
6. **Minsky's theory of crisis and crisis resolution in historical context**
7. Financial crisis in the global South: Orthodox and heterodox explanations
8. The Neoliberal overseas lending/crisis cycle
9. Power in Finance 1: Hegemonic power and TBTF
10. The Subprime Crisis: From financial exclusion to predatory inclusion
11. Power in Finance 2: Financial exploitation and access to credit
12. Post-crisis pressures, debate, and reform efforts
13. Impacts of the global financial crisis on economies in development
14. Shadow banking: escape from regulation, phase 2
15. Power in Finance: Challenges of global regulation
16. Financial regulation

Lecture 1 - From the end of Bretton Woods to Neoliberalism

1. "Classical" vs. Keynesian macro logics
2. Bretton Woods system - Financial stability without globally-induced macro stimulus

   2.1. Cross-border balances
3. Financial markets and large banks: escape from regulation, phase 1
4. Minsky's financial instability hypothesis
5. After the breakdown of Bretton Woods – a cold plunge into the Neoliberal era
6. Minsky's theory of crisis and crisis resolution in historical context

1. "Classical" vs. Keynesian macro logics

- Yesterday and today, Professor Bhaduri introduced a scheme of macroeconomic reproduction based on the concrete conditions of production and distribution.
- His schema was inspired by Michal Kalecki's work. Kalecki picked up Marx's insights on the material basis of production – and advanced ideas about the independence of demand and supply which Rosa Luxembourg explored in *The Accumulation of Capital*. These ideas were put forth as well by Keynes in his *General Theory*.
- Prof. Bhaduri's schema included the Keynesian/Kaleckian feature of independence of demand and supply [when he showed that investment in, say, the finance or banking sectors calls forth more supply - supply becomes demand-dependent].

1. "Classical" vs. Keynesian macro logics

- Marx and Luxembourg were in the trajectory of political economy that can be traced, going backward, to John Stuart Mill, David Ricardo, Adam Smith, and so on. [If you are interested you might look for *Theories of Value and Distribution Since Adam Smith,* Maurice Dobb (Cambridge University Press 1975).]
- One key insight here is that distribution – the level of the wage – is socially determined, not technically determined.
- So economic outputs are always socially determined, in part; but this is invisibilized in later iterations of economic theory; not for nothing is the subtitle of Dobb's book, "Ideology and Economic Theory."

1. "Classical" vs. Keynesian macro logics

- In 1871-74, three economists – Jevons, Walras, and Menger – invented the "marginal revolution," wherein they based economic value on utility. The entire configuration of economic relations can be derived, in this vision, from preferences, endowments, and technology.
- Wages were now understood as equal to the marginal contribution gained by expanding the amount of labor deployed with a given stock of capital. So the distribution of income was seen as technically, not socially, determined.
- Marshall codified this new approach by introducing a new term in his 1890 textbook, *Principles of Economics*.
- Keynes introduces some terminological mischief here.

1. “Classical” vs. Keynesian macro logics

- Keynes discovers the principle of aggregate demand (slightly after Kalecki does in work published in Polish).
- In the marginalist approach, aggregate demand and supply are co-determined; in Keynes/Kalecki, aggregate demand leads.
- In his *General Theory*, which is written in the language of the marginalists so as to convince them, he refers to the marginalist view as “Classical economics” – as opposed to what is now termed “Keynesian” economics.
- He suppressed the material basis of production in his approach, and so too the social basis of wage-setting. Many Keynesians today thus focus on aggregate demand – and uncertainty, which we will come to – and ignore the social dimension and material basis of economic reproduction.

1. "Classical" vs. Keynesian macro logics

- The term "Classical" stuck. So Milton Friedman adapted the term, and with the 1970s we had the rise – with Robert Lucas, Thomas Sargent, Neil Wallace, Edward Prescott, Robert Barro, others – of the "New Classical economics."
- This reasserts the view that the economy is best viewed as a general equilibrium in which choices are disciplined by preferences, endowments, and technology.
- "New Keynesians" accepted this. Roger Farmer, in *Macroeconomics of Self-Fulfilling Prophecies* (MIT, 1993):

> "the future of macroeconomics is as a branch of applied general equilibrium theory."

1. "Classical" vs. Keynesian macro logics

- Then "Keynesian" outcomes are generated by supposing that rigidities – transaction costs, missing information, etc. – shift the economy from 'first best' to 'second best' equilibria.
- His model is "New Keynesian" – we move in worlds of second-best equilibria, but never consider, in formal New Keynesian models: (1) the independent role of aggregate demand; (2) the social basis of distribution (wages); (3) fundamental uncertainty.
- New Keynesians such as Stiglitz and Krugman defend Keynesian ideas in popular writings, but have not challenged the hegemony of general-equilibrium-based macro theory.
- The New Classical model of today has the same logic as the Pigouvian/Marshallian one that Keynes confronted.

Logic of the "classical" model (Part 1)

The classical model is "separable": you can solve one part of it completely before moving on to the next. There are three sections:

1. Solving for N, (W/P), Y

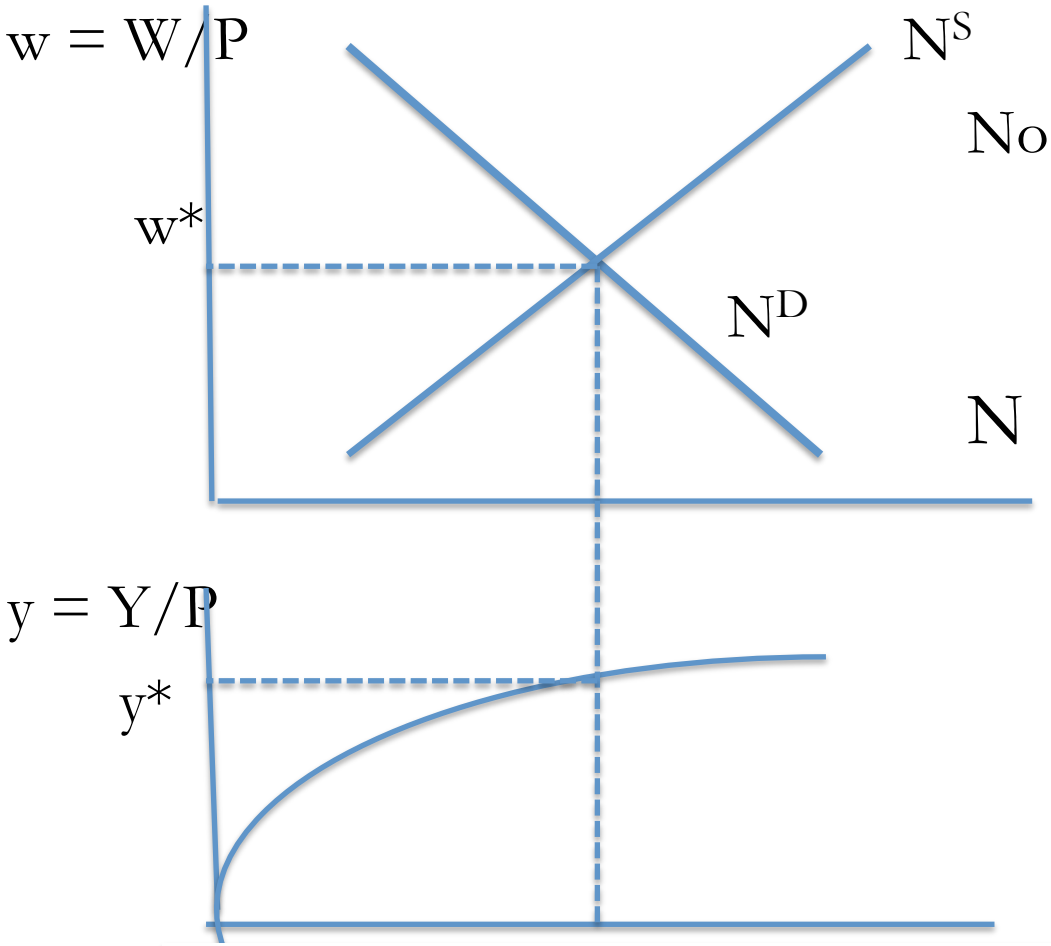
W – nominal wage; P – price level; N – hours of labor time; Y – real output; K – capital.

- Production function $Y = f(N,K)$

  where $f_N > 0$, $f_{NN} < 0$, $f_K > 0$, $f_{KK} < 0$
- Labor demand $N^D = f_N$
- Labor supply $N^S = N^S(W/P)$
- Labor market equilibrium $N^D = N^S$

Classical model in equilibrium

Determination of national employment, real wage, output



No unemployment at w*

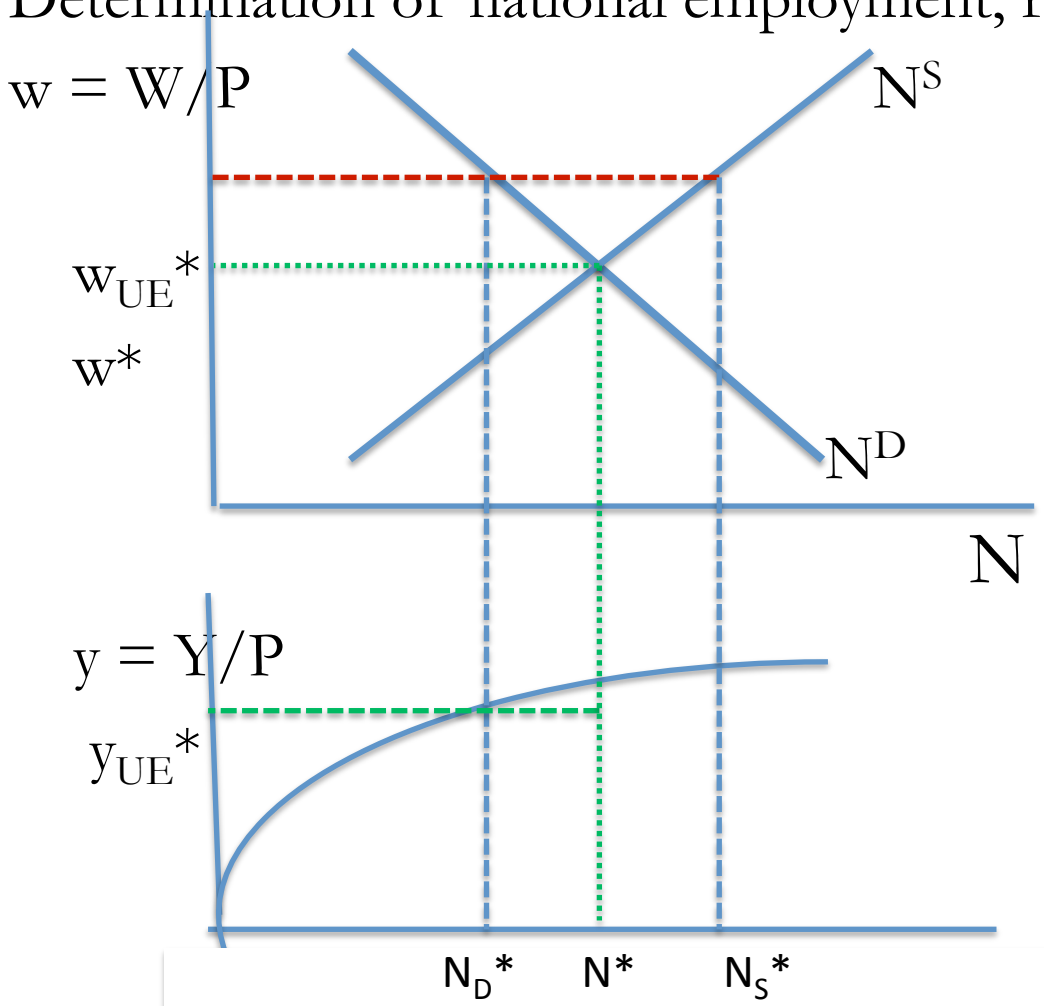
Note that output is determined with no consideration of aggregate demand.

y = real GDP

Y= nominal GDP

Classical model with unemployment equilibrium

Determination of national employment, real wage, output



No UE at w*

How do we eliminate unemployment in this vision of the economy?

y = real GDP

Y= nominal GDP

1. Logic of the classical model (Parts 2, 3)

2. Solving for S, I, R

So we have equilibrium for Y*, N*, (W/P)*. Now, how is output used, and who buys it?

All output is paid out as income (wages, profits, interest, rent).

And all income is used in only a few ways.

Uses of income: $Y = C + S + T$ (C consumption, S saving, T tax)

Demand for income: $Y = C + I + G$ (I – investment, G – govt)

Then Aggregate demand = aggregate supply

$$C + I + G = C + S + T$$

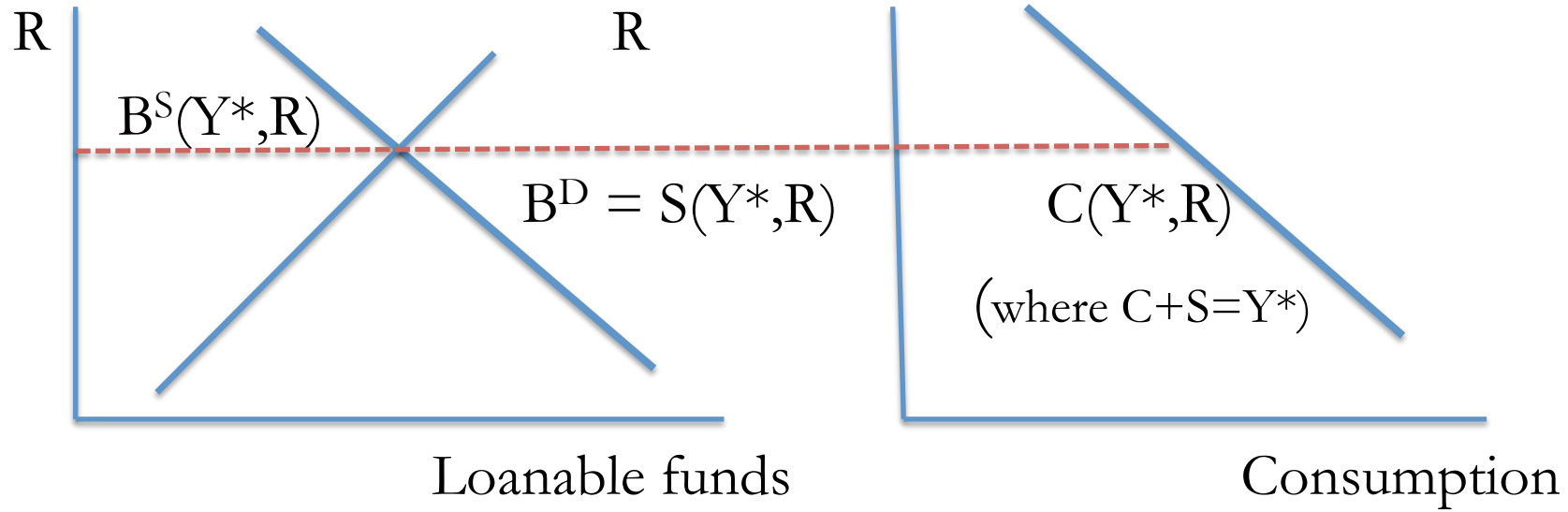
$$I + (G-T) = S$$

Let R denote the interest rate. Then if G is autonomous, and if $T=T(Y^*)$, $I=I(R)$, $S=S(R)$ then

$$I(R^*) + (G-T) = S(R^*)$$

Classical determination of investment, savings

So the "loanable funds" (or 'bond') market determines S, I; and it determines C, by extension. The supply of bonds issued by govt and firms, B^S equals (G-T)+I(R). Then:



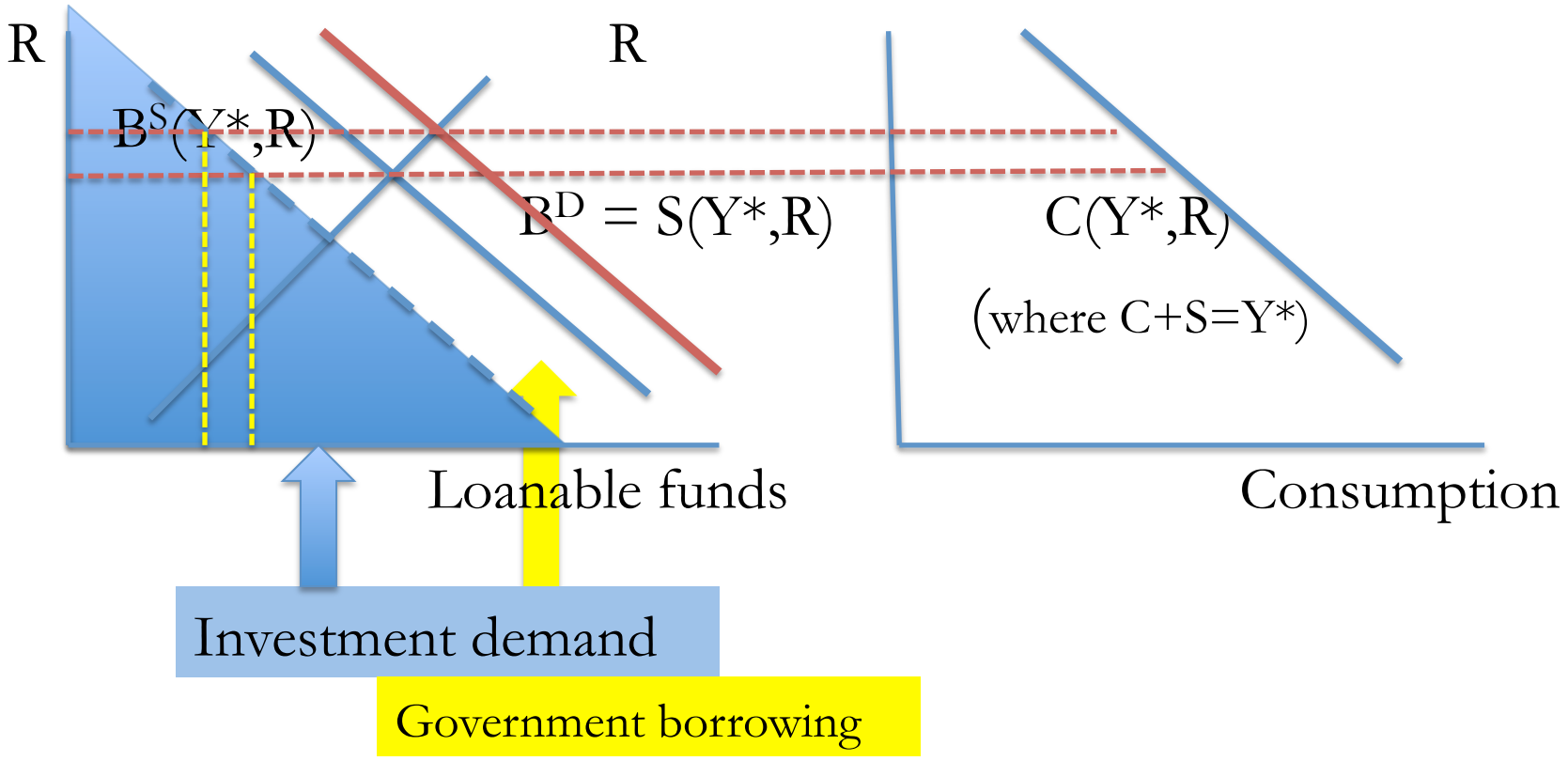
3: Determination of price level, P:

MV = PY* with V velocity is a constant V; and M "money," determined by government, M; then:

P = MV/Y*.

Classical determination of investment, savings

Increased government expenditure not fully supported by tax increases slows the pace of economic growth …



3. Keynesian economics: the key points

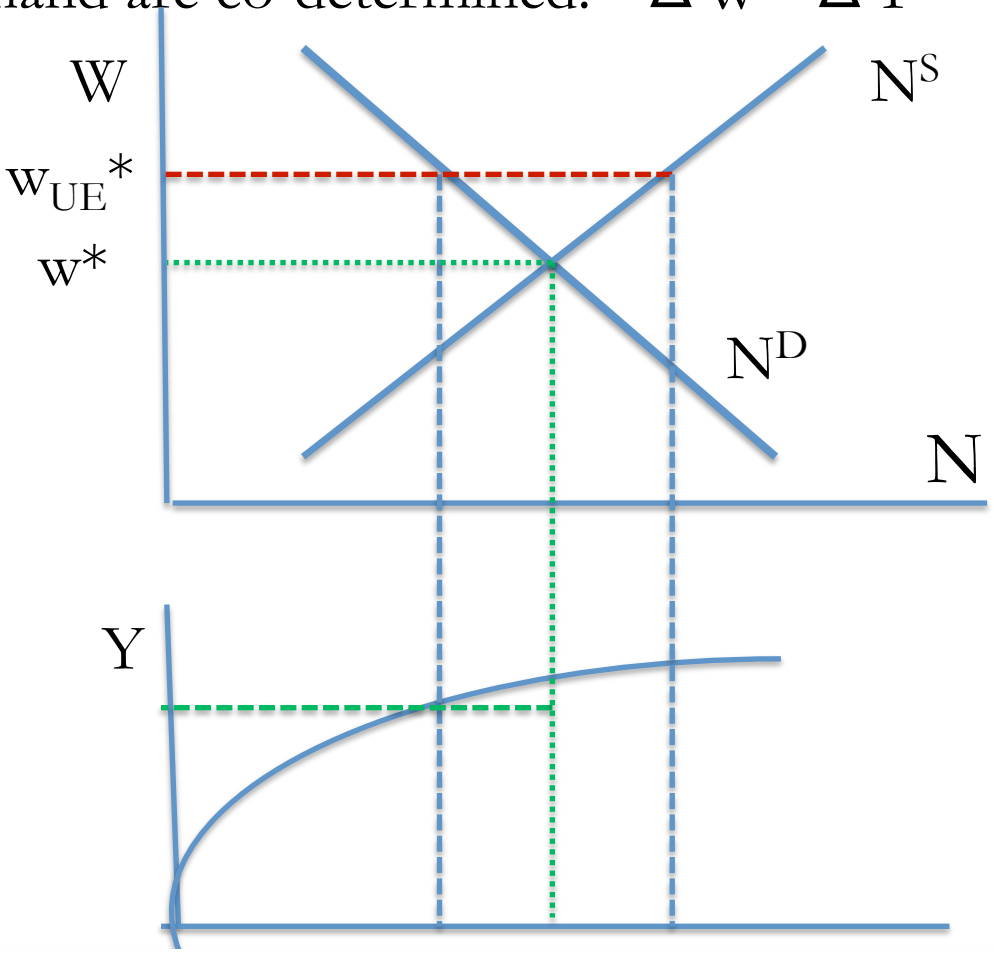
Keynes makes two fundamental points, contrary to the above approach, associated with Pigou and others (the "Treasury view"):

1. Aggregate demand is determined independently of aggregate supply (contrary to "Say's Law:" *supply creates its own demand*).
   - So we need C+I+G=Y to make sense of macro equilibria.
2. Fundamental uncertainty: expectations depend on conventional beliefs, and the degree of confidence in those conventions.
   - When this fails, liquidity preference dominates (1936, Ch. 12, 1937 QJE).

- These points are interrelated – fear leads to a run to money, and kills investment and consumption (and hence aggregate demand)
- When uncertainty breeds fear, government must step in to save the capitalist economy from itself.

Keynes' critique of Classical model of unemployment

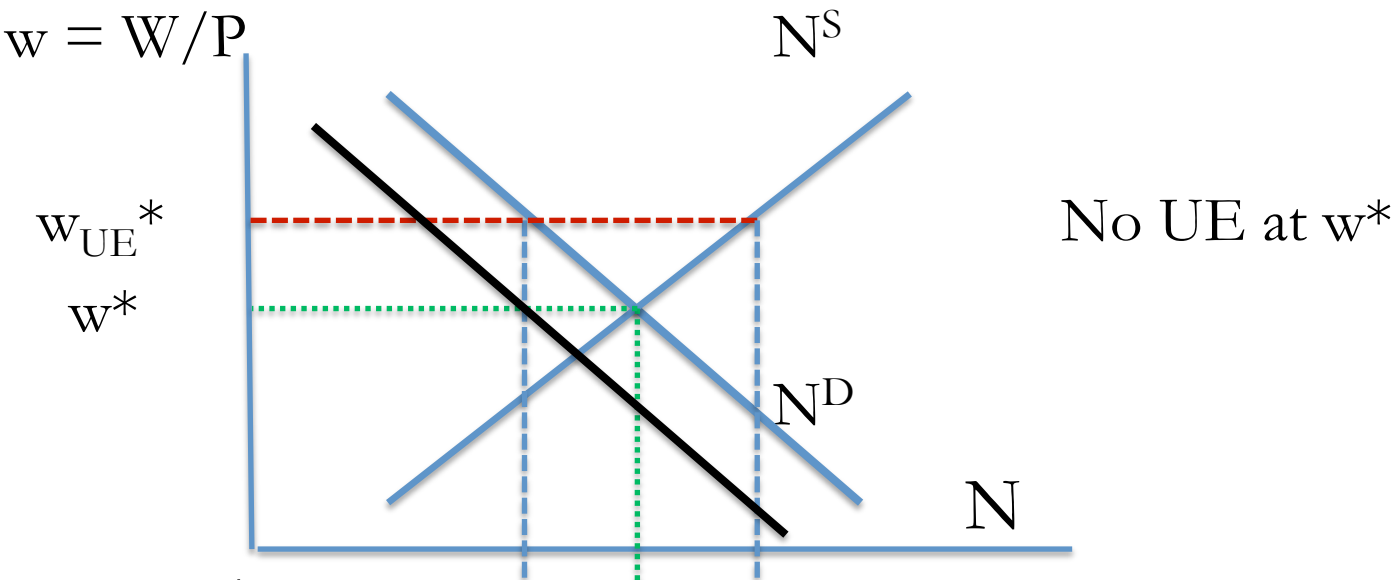
Part 1: So, step one – restore W* (cut wages); but if N and aggregate demand are co-determined: $-\Delta W - \Delta Y^D \rightarrow -\Delta N^D \rightarrow -\Delta Y$ (etc.).



No UE at w*

Keynes' critique of Classical model of unemployment

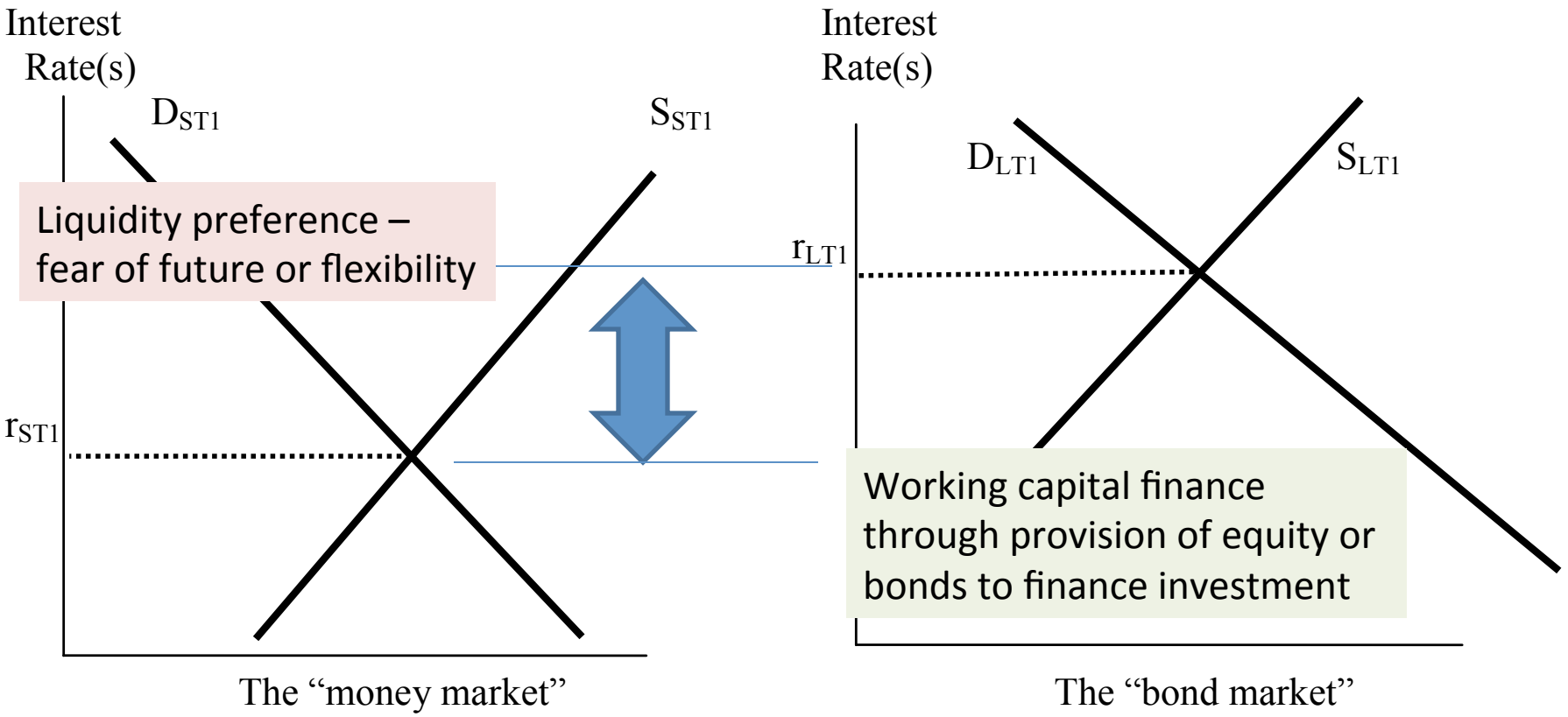
Part 1: Step two: final demand (C+I+G) falls since C depends on w*. Then N^D falls



No UE at w*

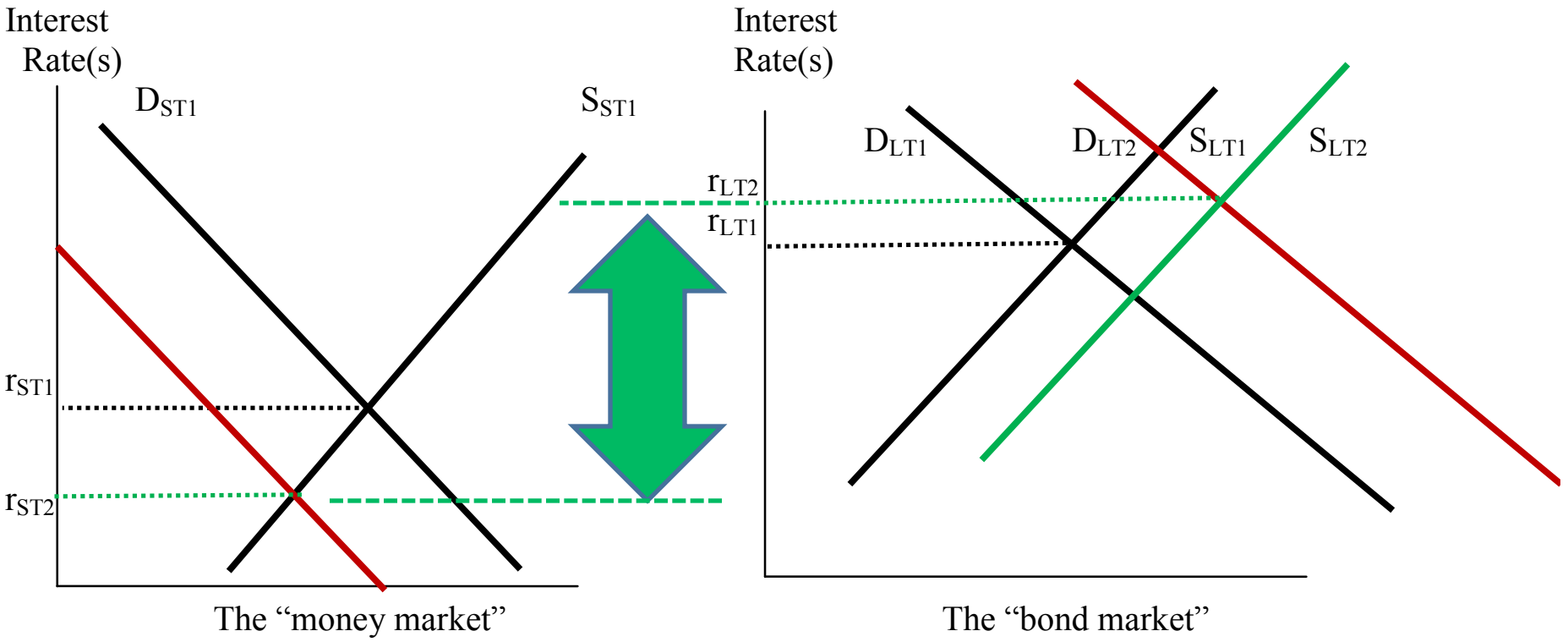
But now you have recreated the problem of 'excess supply of labor at the former w*. So you cut again. Then you recreate the problem again, etc., slowly killing demand for labor, demand for final goods, investment, etc. We don't have here any debt stock, but that would amplify the damage as firms would go bankrupt, banks would call in loans, and so on.

A stylized depiction of core "Keynes" financial markets



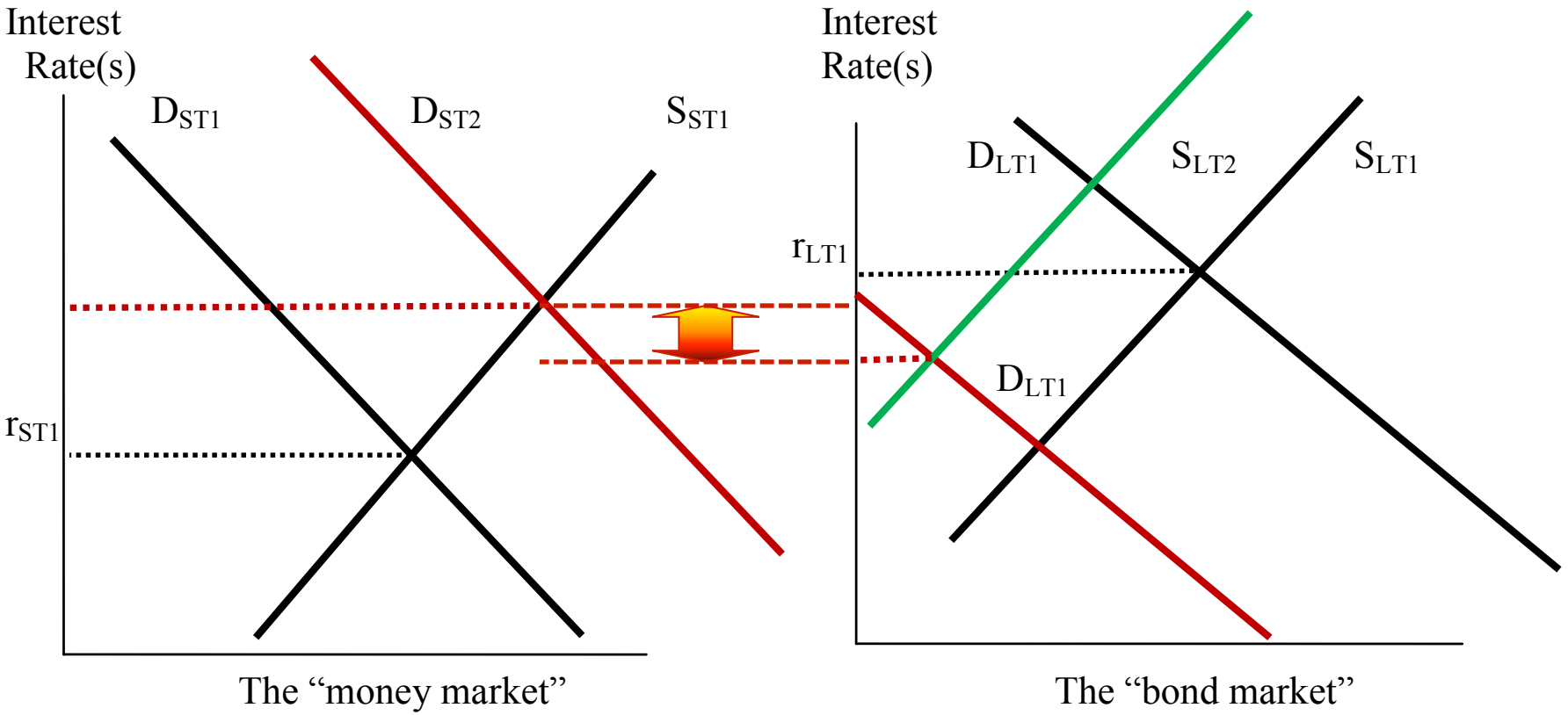
Keynes (*GT* 1936, p. 142): "The habit of overlooking the relation of the rate of interest to hoarding may be a part of the explanation why interest has been usually regarded as the reward for not-spending, whereas in fact it is the reward of not-hoarding."

Investor euphoria in good times



In periods characterized by confidence, investment is readily financed and speculation is rewarded. Investors shed liquidity and move toward yield-generating and 'riskier' assets, the prices of all of which are consistently rising.

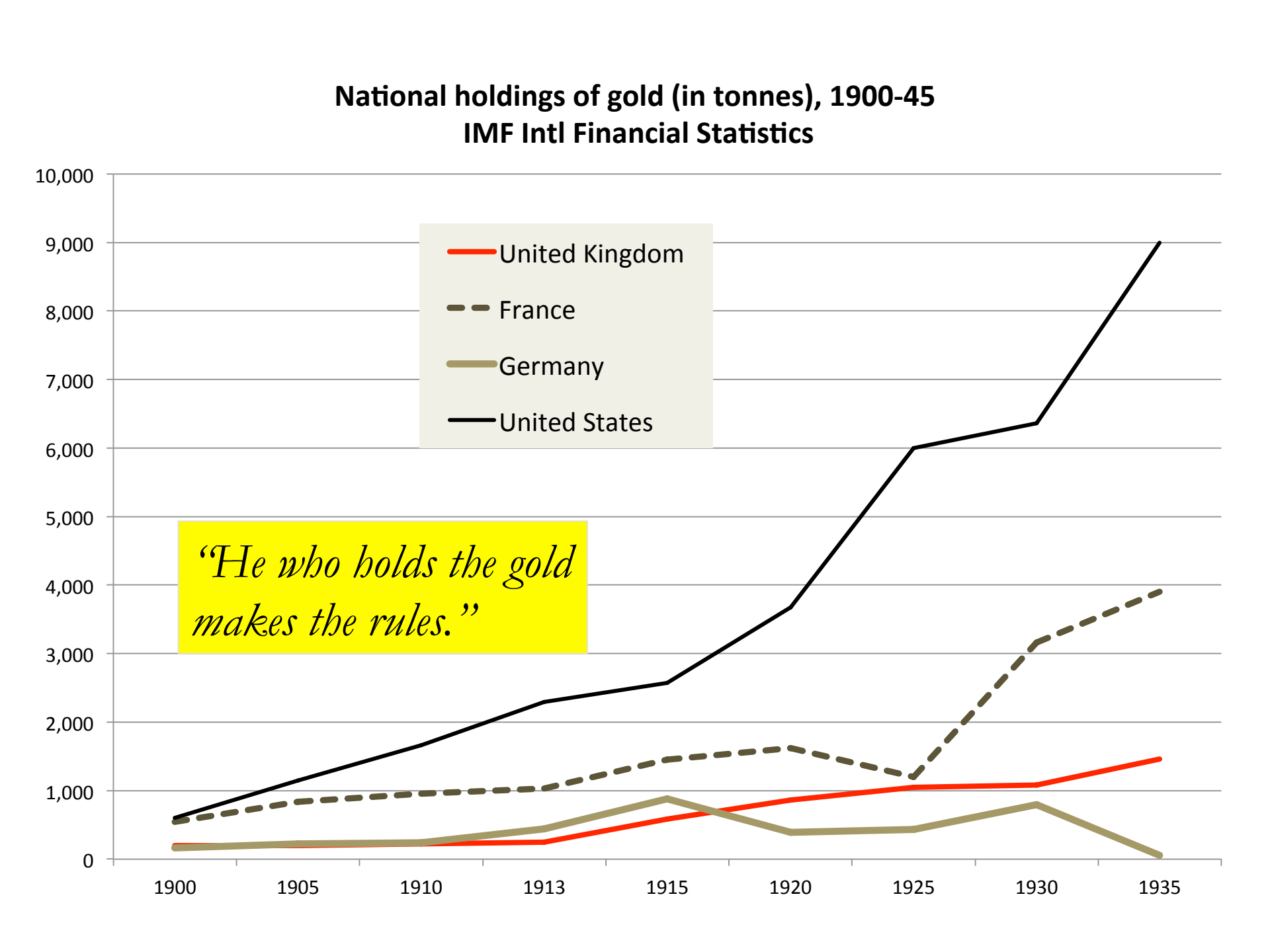
A flight to safety ("hoarding")



When confidence collapses and conventional beliefs converge on the need for safety, "investors" flee from risk.

2. Bretton Woods system - Financial stability without globally-induced macro stimulus

Harry Dexter White, US Assistant Secretary of Treasury for International Affairs; John Maynard Keynes, Cambridge don and advisor to UK Treasury


National holdings of gold (in tonnes), 1900-45
IMF Intl Financial Statistics
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
United Kingdom
France
Germany
United States
"He who holds the gold makes the rules."
1900
1905
1910
1913
1915
1920
1925
1930
1935

2. Bretton Woods system - Financial stability without globally-induced macro stimulus

- Keynes' Bancor system: Surplus nations would be forced to stimulate to reduce external imbalances and stimulate global aggregate demand. Adoption of a globally issued currency by a global central bank, authorized to issue it as needed
- The Bretton Woods system established: Global currency system based on gold-linked currency ($35 dollars = 1 troy oz of gold), with other nations linking their currencies to the dollar
- The US replaced the UK as the hub of a global financial system.
- Like the former gold system, it was confidence-based – and this confidence was underlined by the ability of every participating nation to turn in dollars for gold.
- Further, its viability depended on nations *not* turning in dollars for gold.

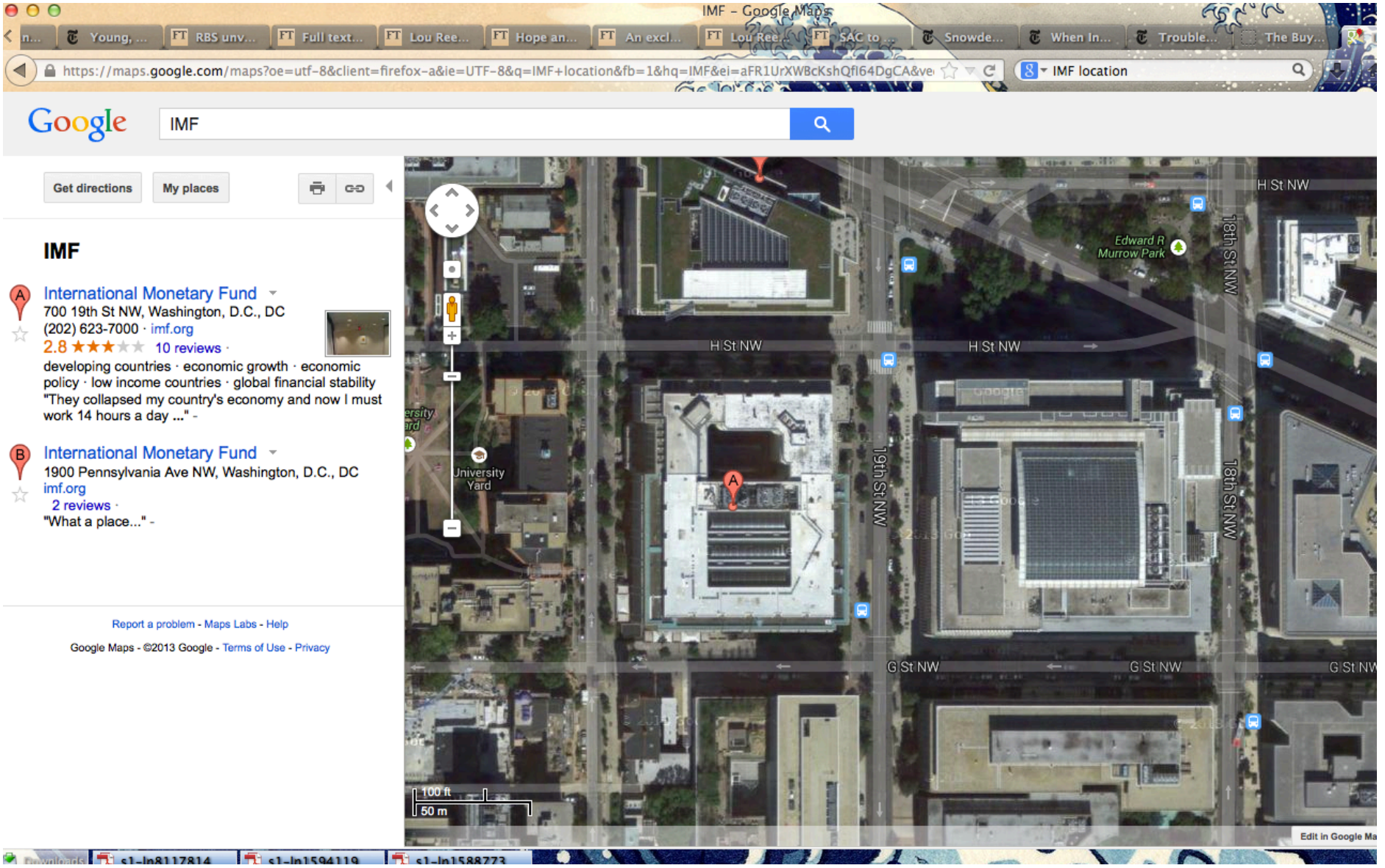
Bretton Woods system - Financial stability without globally-induced macro stimulus

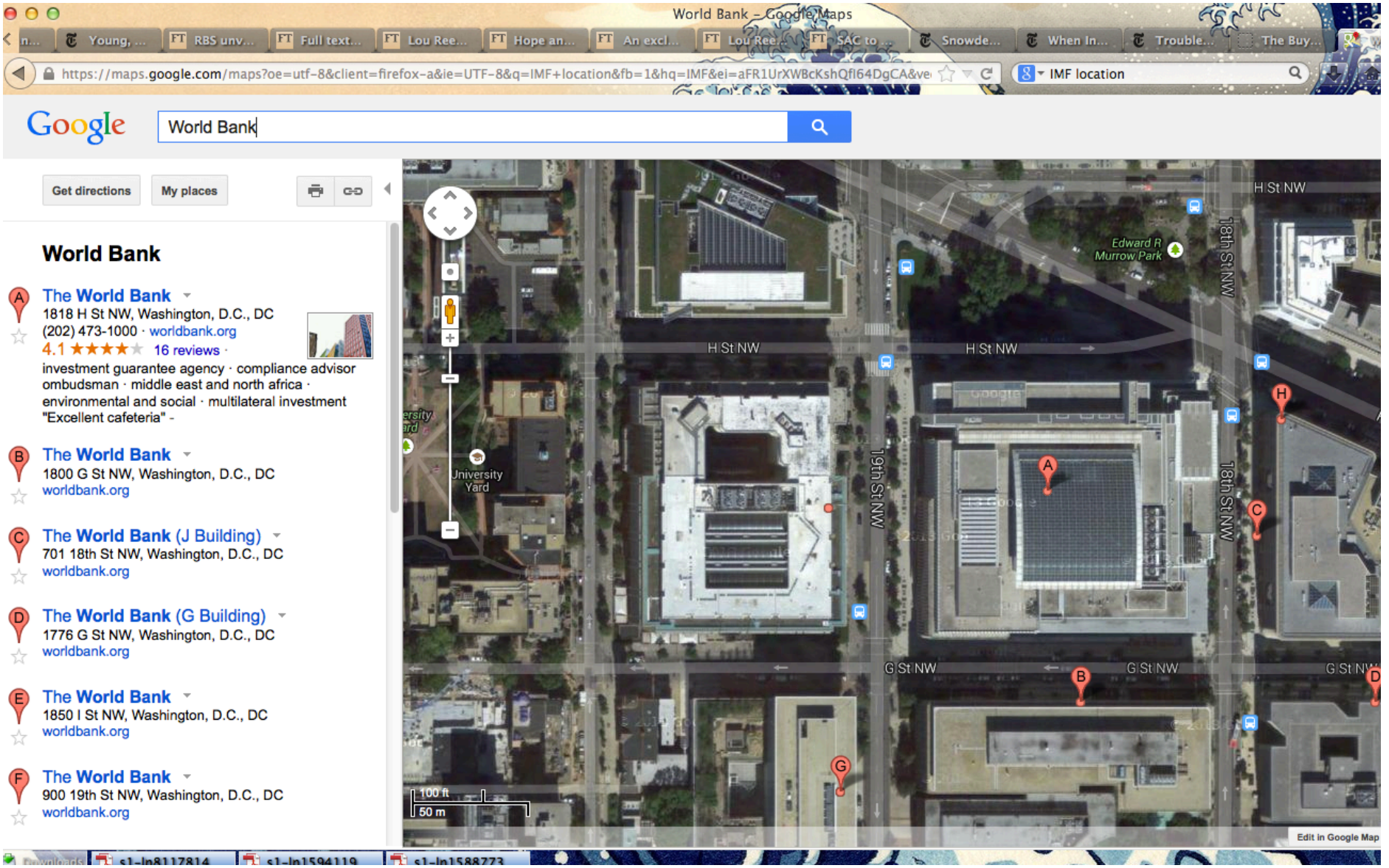
- The US came out of WWII with 50% of global manufacturing capacity. It had a huge surplus on current account. This removes dollars from the rest of the world, which is supposed to use dollars to make transactions.
- This was part of the logic of the Marshall Plan: it put dollars into circulation in Europe and also stimulated those economies.
- The Cold War with the USSR (and hot wars in Korea, then Vietnam) incentivized the US to have successful allies
- This was a world of Keynesian national budgets (welfare state, military conflicts, and so on), but with Classical global adjustment mechanisms. Why the latter? The mandate of the International Monetary Fund

Bretton Woods system - Financial stability without globally-induced macro stimulus

The Bretton Woods system established IFI's (international financial institutions) per the US plan. The components:

- IMF: an internationally-overseen, US-dominated institution focused on short-term adjustment to correct payments deficits or overseas indebtedness (Location: 19th and H, SW corner, Washington DC)
  - a fund, not a central bank or a lender of last resort
  - led by a non-US citizen, and it is overseen by a board of representatives of global nations
- World Bank: an internationally-overseen, US-dominated institution funding long-term investment projects in emerging-market economies lacking adequate financing capacity to (Location: 19th and H, SE corner, Washington DC)
  - led by a US citizen appointed by the President; a fund, not a bank, its resources limited to its subscriptions


IMF - Google Maps
https://maps.google.com/maps?oe=utf-8&client=firefox-a&ie=UTF-8&q=IMF+location&fb=1&hq=IMF&ei=aFR1UrXWBcKshQfI64DgCA&ve
IMF location
Google
IMF
Get directions
My places
IMF
International Monetary Fund
700 19th St NW, Washington, D.C., DC
(202) 623-7000 · imf.org
2.8 ★★★☆☆ 10 reviews ·
developing countries · economic growth · economic policy · low income countries · global financial stability
"They collapsed my country's economy and now I must work 14 hours a day ..." -
International Monetary Fund
1900 Pennsylvania Ave NW, Washington, D.C., DC
imf.org
2 reviews ·
"What a place..." -
Report a problem - Maps Labs - Help
Google Maps - ©2013 Google - Terms of Use - Privacy
H St NW
H St NW
H St NW
Edward R Murrow Park
18th St NW
19th St NW
18th St NW
University Yard
G St NW
G St NW
G St NW
100 ft
50 m
Edit in Google Ma


World Bank – Google Maps
https://maps.google.com/maps?oe=utf-8&client=firefox-a&ie=UTF-8&q=IMF+location&fb=1&hq=IMF&ei=aFR1UrXWBcKshQfI64DgCA&ve
IMF location
Google
World Bank
Get directions
My places
World Bank
A The World Bank
1818 H St NW, Washington, D.C., DC
(202) 473-1000 · worldbank.org
4.1 ★★★★☆ 16 reviews ·
investment guarantee agency · compliance advisor ombudsman · middle east and north africa · environmental and social · multilateral investment
"Excellent cafeteria" -
B The World Bank
1800 G St NW, Washington, D.C., DC
worldbank.org
C The World Bank (J Building)
701 18th St NW, Washington, D.C., DC
worldbank.org
D The World Bank (G Building)
1776 G St NW, Washington, D.C., DC
worldbank.org
E The World Bank
1850 I St NW, Washington, D.C., DC
worldbank.org
F The World Bank
900 19th St NW, Washington, D.C., DC
worldbank.org
H St NW
Edward R Murrow Park
18th St NW
19th St NW
University Yard
G St NW
100 ft
50 m
Edit in Google Map

1. Bretton Woods system - Financial stability without globally-induced macro stimulus

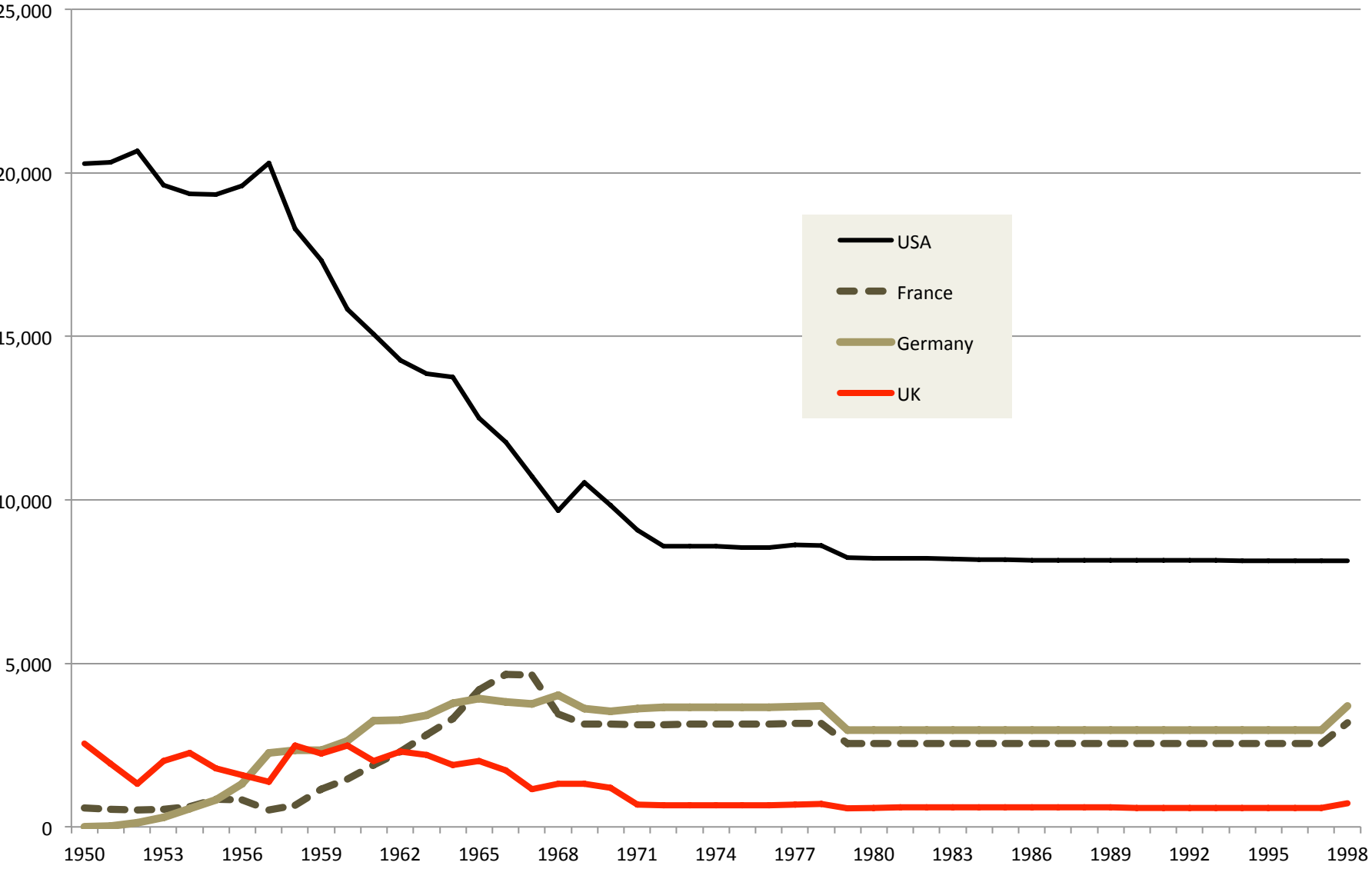
Embodies the contradiction built into any gold-standard system: the hegemonic nation either starves other nations of gold, forcing them into contraction (mild) or debt-deflations (severe); or it releases gold into the rest of the system and thereby proves its weakness.

In the Bretton Woods system, the recovery of Europe and Asia, and the emergence of Germany and Japan as the powerhouses of these nations, led the US from a surplus-nation to deficit-nation status.

Britain struggled with $5.86/£, had to devalue, to $4.86/£ in 1966.

France pushed against US dominance and cashed its $ to gold. The overvalued $ permitted US corporations to buy up assets in France and elsewhere. Jean Servan-Shreiber wrote "*Le Défi Américain*" (The American Challenge, 1967).

Tonnes of gold held by national treasuries, 1950-98



2.1. Basic logic of cross-border macro balance

- Flows across borders must balance for every spatial area:

  Current account = -[Capital inflows] + Δ reserves

  Current account = trade flows plus repatriated profits, debt flows, remittances by guest workers (X – M, where X denotes all exports, M denotes all imports)

- Trade flows (or capital flows) between any two countries need not balance. But the sum of trade flows across all bordered economies must equal zero for any time period
- The sum of net capital in- and outflows must equal zero.
- If (n-1) countries have current-account surpluses, the n^{th} country must be in deficit.

Basic logic of cross-border macro balance

$$X - M = -[\text{Capital inflows}] + \Delta \text{reserves}$$

$$\text{Capital inflows} \cong \text{foreign savings}$$

Then define foreign(ers') savings as S_F, Δ reserves as ΔR:

$$X - M = -S_F + \Delta R$$

So if $X > M$ and ΔR, $S_F < 0$

Now the macro equilibrium of one nation-state:

$$\text{Aggregate Demand} = \text{Aggregate Supply}$$

$$C + I + G + X = Y$$

But supply can be represented as by the uses of income:

$$C + I + G + X = C + S + T + M$$

$$\text{Then, } I + (G-T) = S - (X-M)$$

Basic logic of cross-border macro balance

This "GDP/national balance" has a border-crossing term:

$$I + (G-T) = S \mathbf{- (X-M)}$$

Now recall our border-crossing balance:

$$X - M = - S_F + \Delta R$$

Substitute the latter into the former so all the information is captured in one expression. Rearranging:

$$I + (G-T) = S \mathbf{+ S_F - \Delta R}$$

Here is that 'master' equation: "what must be financed" = "what is available to finance it with."

Every spatial area has to solve this problem, in each time-period.

Basic logic: what the IMF wants

Follow these rules:

- If you have zero (public) debt to pay and a balanced budget (G = T), then seek cross-border balance.
- If you have (public) debt to pay and cannot balance your budget (G+rD > T), then you have a deficit and a credibility problem. So you need X-M>0.
  - Either global growth speeds up or your growth slows down.
- This analysis and the conclusions that follow are *technical*.

3. Financial markets and large banks: escape from regulation, phase 1

- Financial markets are growing in size (number of shares, volume of sales) in the post-war period.
- So "efficient market hypothesis" replaces the idea of "stock-picking" based on company fundamentals.
- This leads to "portfolio diversification" (James Tobin).
- As the financial markets grow, the large banks that serve them find ways to get around limits on their own portfolio size: hence, liability management (dependence on bought funds) emerges in 1960s.
- This leads to credit crunches, even financial crises – market meltdowns.

Hyman P. Minsky, 1919-1996

The Financial Instability Hypothesis

Books: *Can 'It' Happen Again?* (1982)
John Maynard Keynes (1975)
Stabilizing the Unstable Economy (1986)

4. Minsky's financial instability hypothesis

- Minsky's "Financial Instability Hypothesis" – A comprehensive and yet incomplete framework, suggesting micro (firm-level), market, and macroeconomic (aggregate) behavior and dynamics
- Micro (firm): The balance sheet perspective (Robust, fragile, or Ponzi economic units)
- Market (investment theory): The "two-price" model
- Macro (aggregate):
  - A Business-cycle perspective (US 1960s-1970s)
  - "Big government", "Big bank" as appropriate policy responses when crisis hits.
- Minsky suggested that his two-price model was equivalent to "theory q", developed by James Tobin as an arbitrage theory of investment in equilibrium. But this was not a happy linkage.

Financial Structure of a Typical Firm	
ASSETS	*= LIABILITIES + NET WORTH*
Cash	Short-term credit: working-capital loan, trade credit, etc.
Inventory and accounts receivable	
Equipment, raw materials, goods in process, intermediate goods	Long-term loans and bonds
Buildings, durable capital assets	Equity

K

D

Micro dimension: Suppose there is an interest rate *R* that has to be paid on all debt, *D*. A firm has productive assets *K* which will either receive a high return *P* or a low one *p*.

Then the firm's expected cash-flow is:

$$E\pi = \Pr(P)\ PK + (1-\Pr(P))\ pK - RD$$

And at the "end" of this period, this firm's earnings have to cover its debt obligations. In this case, the questions are:

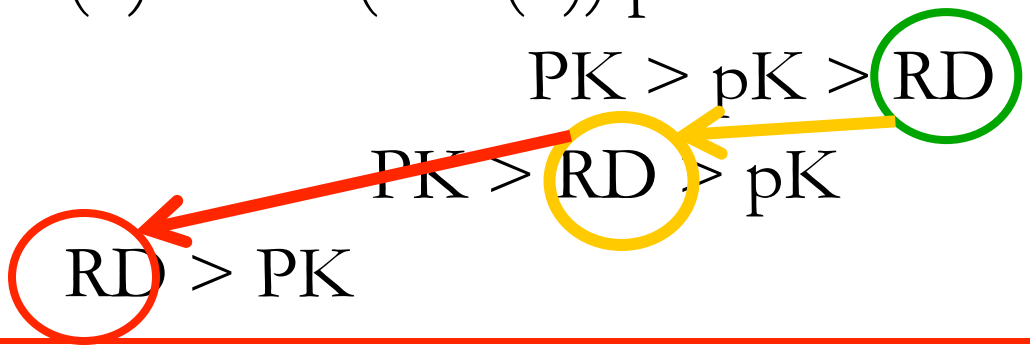
Does $PK \geq RD$? And does $pK \geq RD$?

$$E\pi = \Pr(P)\,PK + (1-\Pr(P))\,pK - RD$$

Robust unit: $PK > pK > RD$

Fragile unit: $PK > RD > pK$

Ponzi unit: $RD > PK$



Minsky saw firms as undergoing an evolution over the business cycle, from "robust" to "fragile" to "Ponzi" finance. They would be driven by competition for profits, and by euphoria.

Note that "Ponzi" units are sometimes depicted as "losers" who just drain money from others – Madoff-type or AMWAY-type "ponzi schemes". But this is not a necessary condition.

As production or commitments increase, and/or as the cycle deepens, it becomes more and more risky for both the firm and its lender to expand.

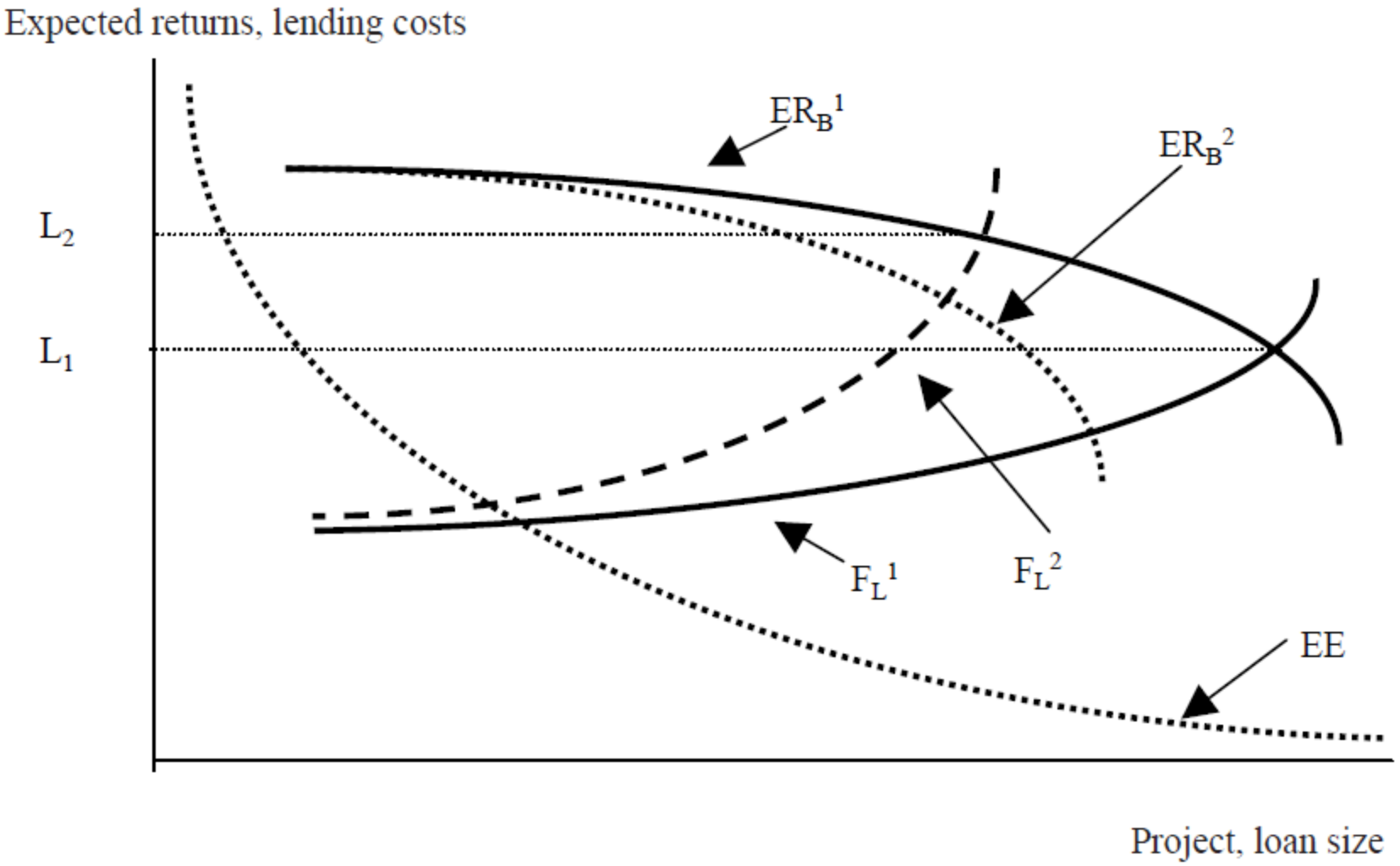


Figure 3. Minsky's depiction of financial crisis microfoundations

1. Typical Firm – Robust Financial Structure	
ASSETS	*= LIABILITIES + NET WORTH*
Cash	Short-term credit: working-capital loan, trade credit, etc.
Inventory and accounts receivable	
Equipment, raw materials, goods in process, intermediate goods	Long-term loans and bonds
Buildings, durable capital assets	Equity

2. Typical Firm – Fragile Financial Structure	
Cash	Short-term credit: working-capital loan, trade credit, etc.
Inventory and accounts receivable	
Equipment, raw materials, goods in process, intermediate goods	Long-term loans and bonds
Buildings, durable capital assets	Equity

Shift to more **leverage** leads to more expected gain, but also more financial fragility .. Dependence on affordable **liquidity** when it's needed.

Minsky's own presentation of his theory was problematic.

Two-price model: P_K, the imputed price of capital in financial markets as a ratio of P_I, the (real) 'supply price' of investment goods. Then:

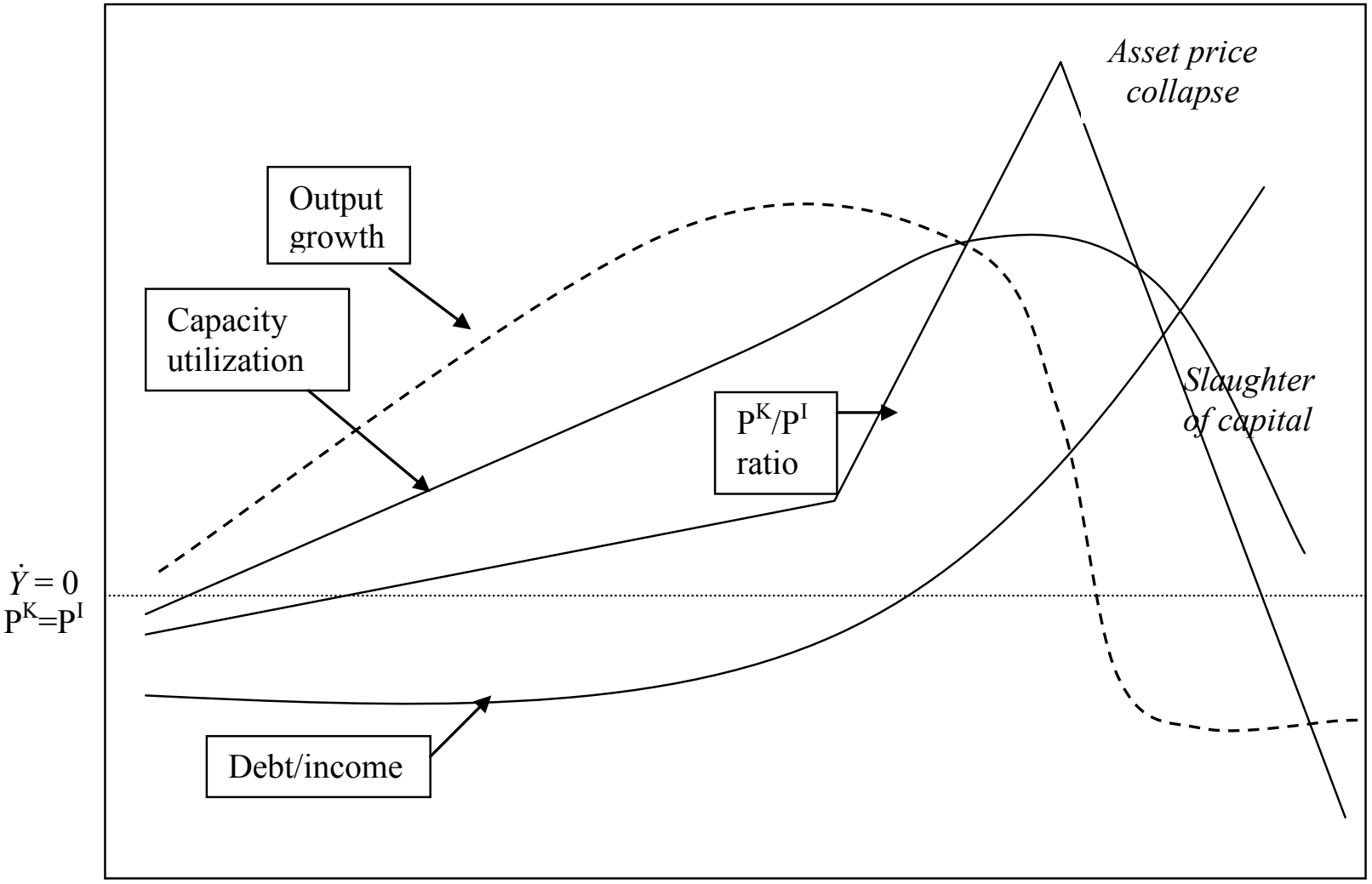
If $P_K/P_I > 1$, build a factory & capitalize it by selling shares

If $P_K/P_I < 1$, buy an existing factory, don't build one.

Problems here:

- Minsky's idea requires uncertainty, and this is a portfolio-equilibrium theory of investment (Tobin's "theory Q")
- Economic units "invest" by arbitraging price differences between the real and financial sectors.

The Macroeconomic level: A stylized picture of a Minsky crisis



Stages: Robust ⟶ Fragile ⟶ Ponzi ⟶ Collapse

NOTE: The variables shown are measured against cyclical trend, with time elapsing from left to right in the diagram.

The Role of Banks in Minsky's Vision of Financial Instability

For Minsky, economic units move systematically in the business cycle from robust to financially-fragile to Ponzi.

He liked to say that "all economic units are banks."

True, but: banks *per se* emit liquid deposits and create credit.

Non-banks depend on banks to provide them with liquidity; banks must go find that liquidity.

For banks – *lenders* - tension arises over the cycle between liquidity-provision and credit-creation.

Then the secret to getting out of the crisis is fixing the banks, restoring their ability to lend and support non-bank units (Minsky assumed, 'banks are *productive* and *economically functional.')*

1. Typical Bank – Robust Phase of Financial Structures

ASSETS	*= LIABILITIES + NET WORTH*
Reserves	Deposits
Securities	
Loans	Money-market Borrowing
	Equity

2. Typical Bank – Fragile Phase of Financial Structure

Reserves	Deposits
Securities	
Loans	Money-market Borrowing
	Equity

Leverage expands with loan-making (deposit creation) & with borrowing.

Default risk grows as more loans are made and they become riskier; **liquidity risk** grows as the bank borrows more heavily to support its asset position.

There are two pressure points in the Minsky cycle:

1. Banks become increasingly reluctant to lend as liquidity risk rises; if it's all held on banks' balance sheets, banks will slow lending and the pace of economic activity.

   (In the "small government" era, this would lead to debt-deflation.)

2. The central bank can intervene as lender of last resort: providing liquidity, permitting banks to lend, renewing pace of economic activity.

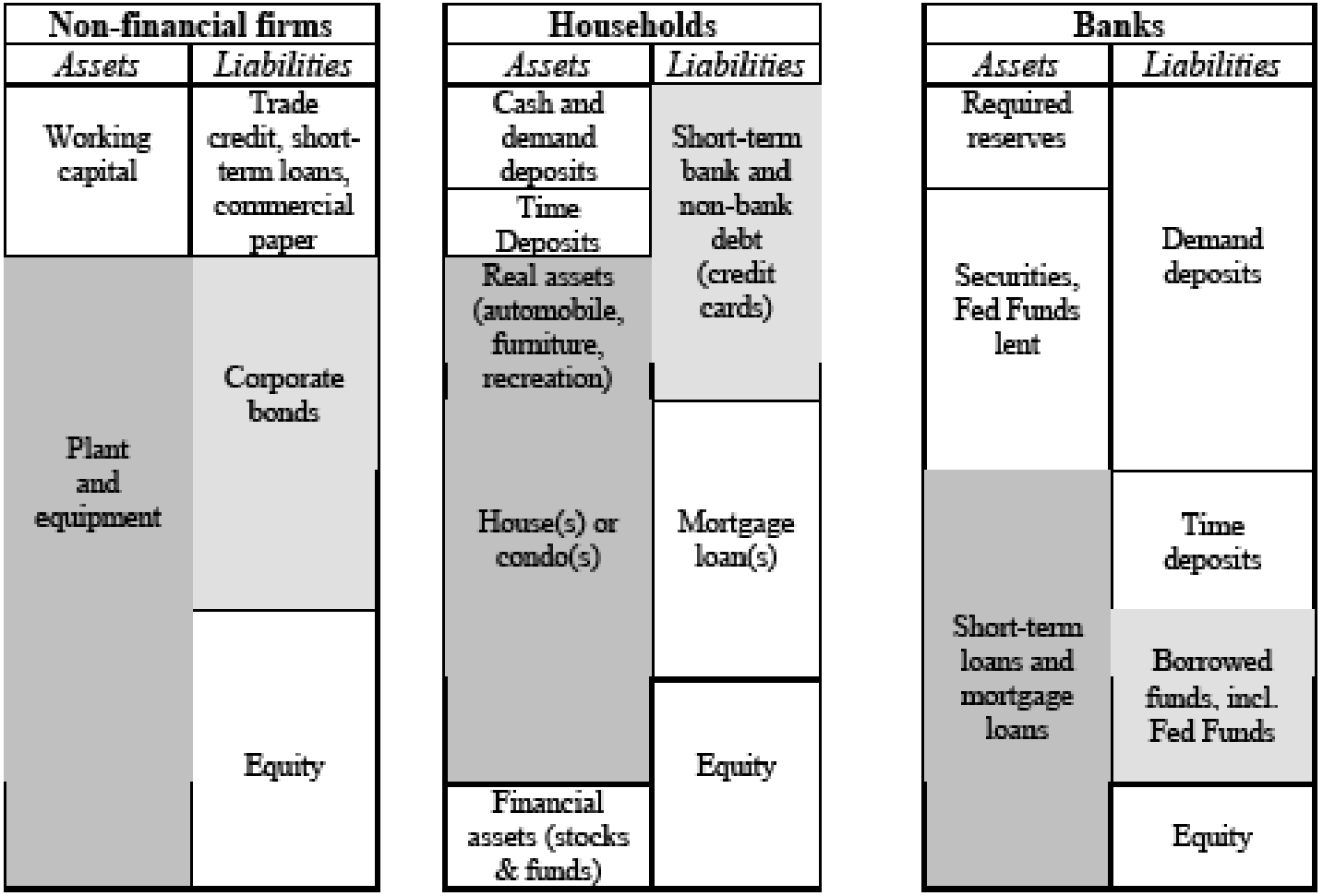
   (In the "big government" era, "big government" and the "big bank" intervene to stabilize .. If they're not obsessed with inflationary expectations (or the expectation that financial markets will expect inflation if they use their policy tools)…

Minsky's characterization of crisis & recovery rests on several stylized facts:

- Banks are the most highly leveraged units, & thus especially vulnerable to default & liquidity risk.
- So governmental interventions to stabilize the economy are most likely to rescue banks, which have the smallest equity cushions.
- This brings us to an anomaly: if Minsky presents a "balance-sheet view,"why is his analysis based on cash-flows and not balance sheet positions?
- The answer: banks approach insolvency before other units, in the downturn.

(non-bank firms' leverage
< households' leverage
< banks' leverage)

Figure 1: Firms, households, and banks: pre-deregulation balance sheets



Note: Dark gray indicates locii of default risk; light gray indicates locii of liquidity risk. Household

So central-bank lender-of-last-resort support for banks (including 'looser' monetary policy) can "stabilize the unstable economy", since:

1. Banks are the **most leveraged units** in the economy
2. They undertake **half or more** of all intermediated credit-creation
3. Banks' balance sheets are **the locus of liquidity risk** within the economy
4. Banks have important **borrower-lender relationships and knowledge** which they can use to renew economic growth through expanding their lending.
5. Renewed bank lending can thus help stabilize markets and revive **investment spending**; (which commercial-bank loans does not finance).

PREMISES: When there is a speculative asset bubble, banks' lending is not the source of it.

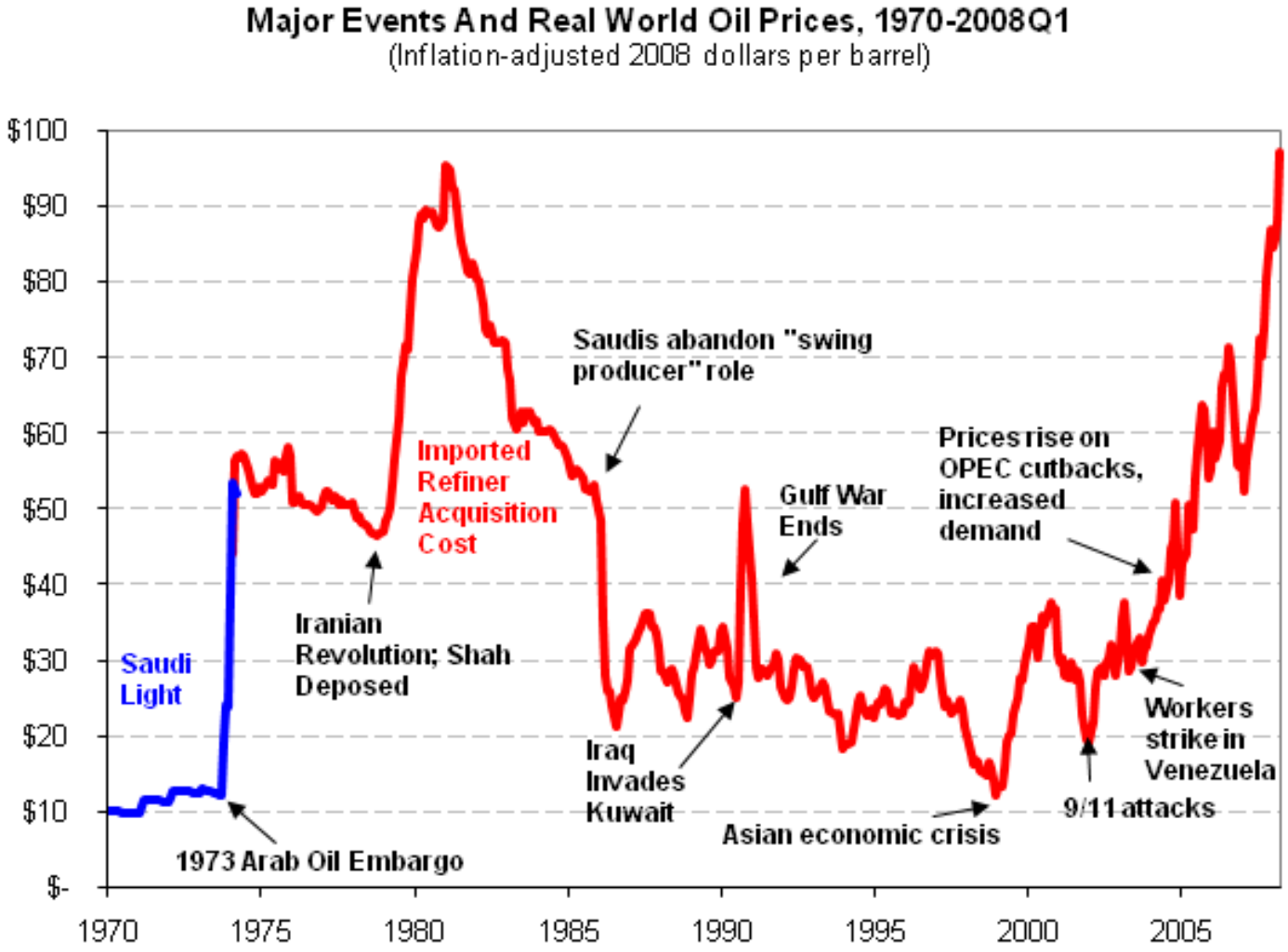
The bigger the bank, the more important its role in this rescue process.

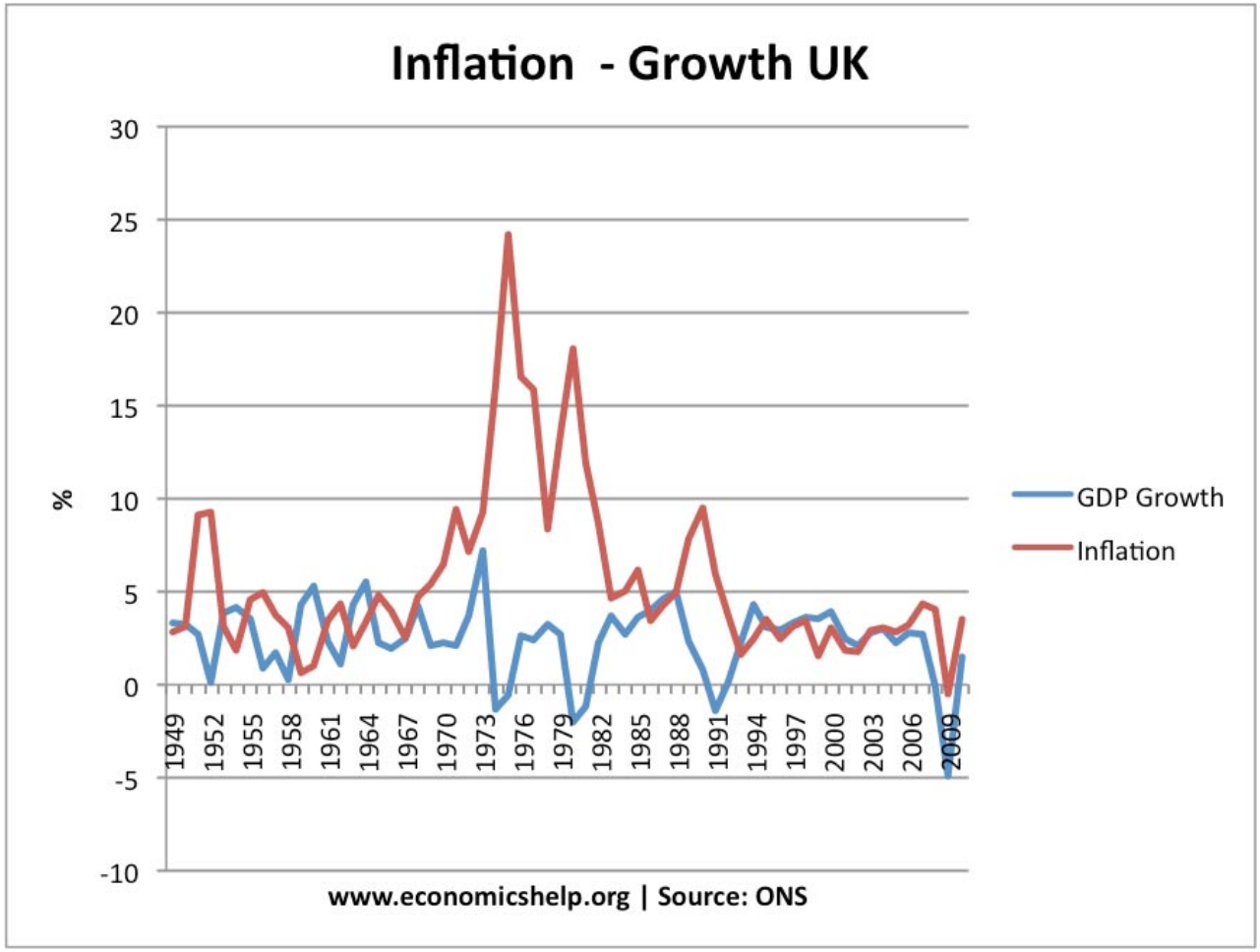
5. After the breakdown of Bretton Woods – a cold plunge into Neoliberal era

- US balance-of-payments problems (European, Japanese industrial renewal, Vietnam War, rentier behavior by US MNCs)
- Fed tries to slow down pace of economy, in part by monetary policy: but large banks fight against this by creating new borrowing instruments/markets.
- The proud hegemon imposed capital controls as of 1963 (!) to protect the dollar. Kindleberger, Salant, Despres (1966) argued that the US trade deficit was solving a global liquidity crisis.
- But confidence in [US$ = gold] declined, credit crunches occurred.
- The "Keynesian consensus" model crashes and burns (large econometric models using 1950s-60s data to explain the 1970s.

After the breakdown of Bretton Woods – a cold plunge into Neoliberal era

- The pressure of an overvalued dollar built up on the US. It was leaking gold, and suffering contractionary pressure.
- Pres. Nixon suspended gold convertibility of dollar in August 1971.
- Nixon imposed wage-price controls in 1972 to control inflationary pressure; then he ended the dollar peg to gold in August 1973.
- The Golden Age of American hegemony – the American Century - had lasted just 25 years.
- Supply-side shock and era of limits, banking destabilization
- The Empire strikes back (1979-1982): the Volcker Shock …
- … Latin American debt crisis

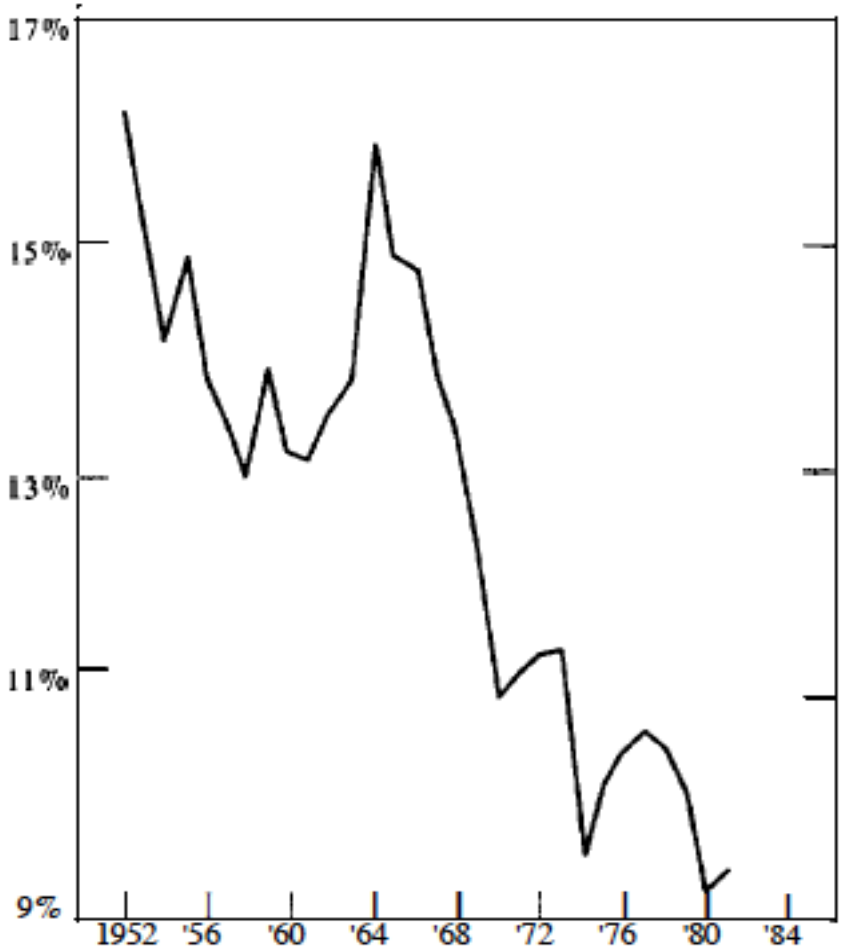

Major Events And Real World Oil Prices, 1970-2008Q1
(Inflation-adjusted 2008 dollars per barrel)
$100
$90
$80
$70
$60
$50
$40
$30
$20
$10
$-
1970
1975
1980
1985
1990
1995
2000
2005
Saudi Light
Imported Refiner Acquisition Cost
1973 Arab Oil Embargo
Iranian Revolution; Shah Deposed
Saudis abandon "swing producer" role
Iraq Invades Kuwait
Gulf War Ends
Asian economic crisis
Prices rise on OPEC cutbacks, increased demand
9/11 attacks
Workers strike in Venezuela


Inflation - Growth UK
30
25
20
15
10
5
0
-5
-10
%
1949
1952
1955
1958
1961
1964
1967
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
2000
2003
2006
2009
GDP Growth
Inflation
www.economicshelp.org | Source: ONS

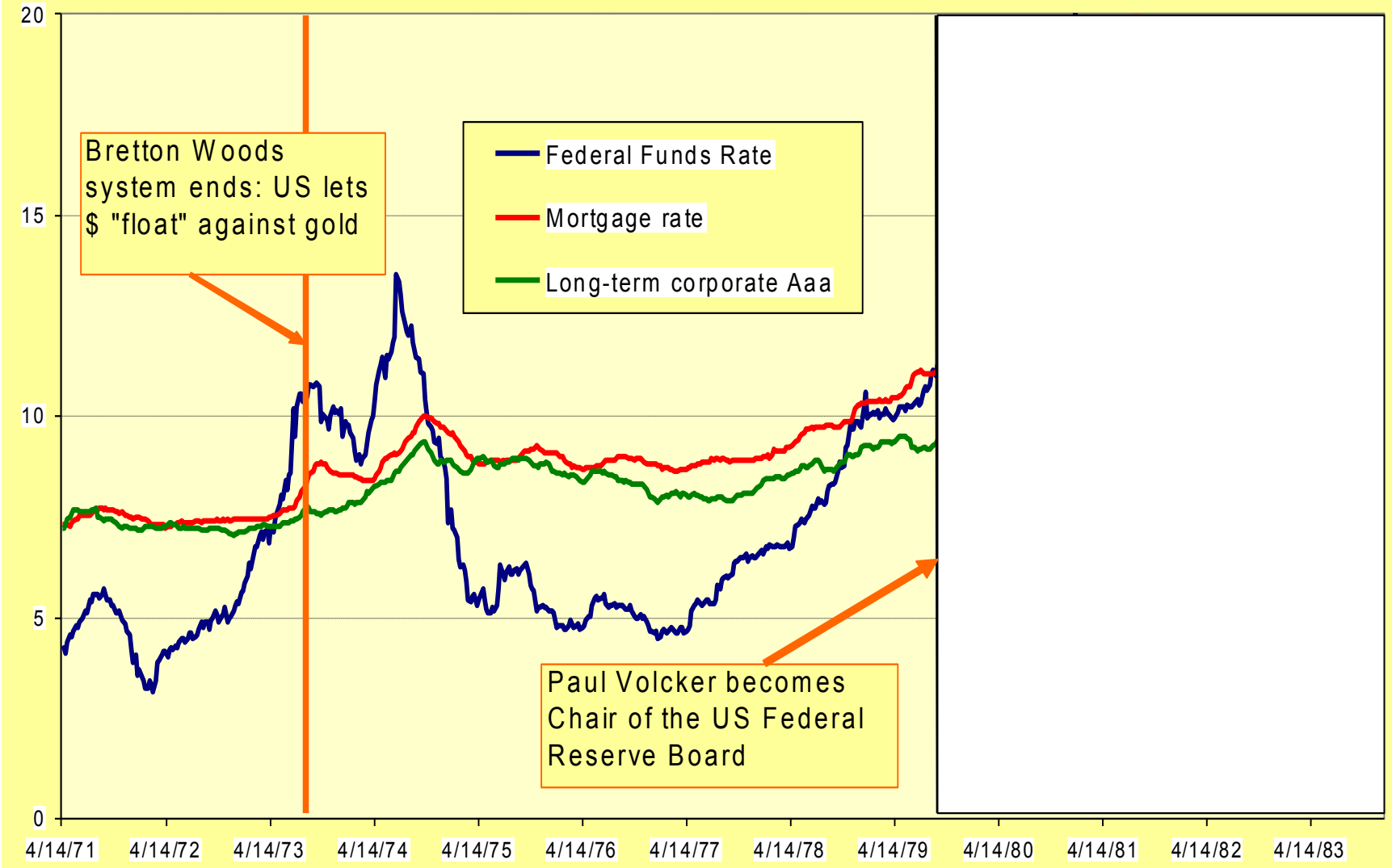
The Decline in Business Profitability: A Disaggregated Analysis

Dale Allman, *Economic Review* of the Federal Reserve Bank of Kansas City, January 1983

Chart 1
BEFORE-TAX PROFITS AS A RETURN TO CAPITAL IN ALL U.S. BUSINESS



Selected US Interest Rates, 1971-1979



The Volcker era: the Empire strikes back

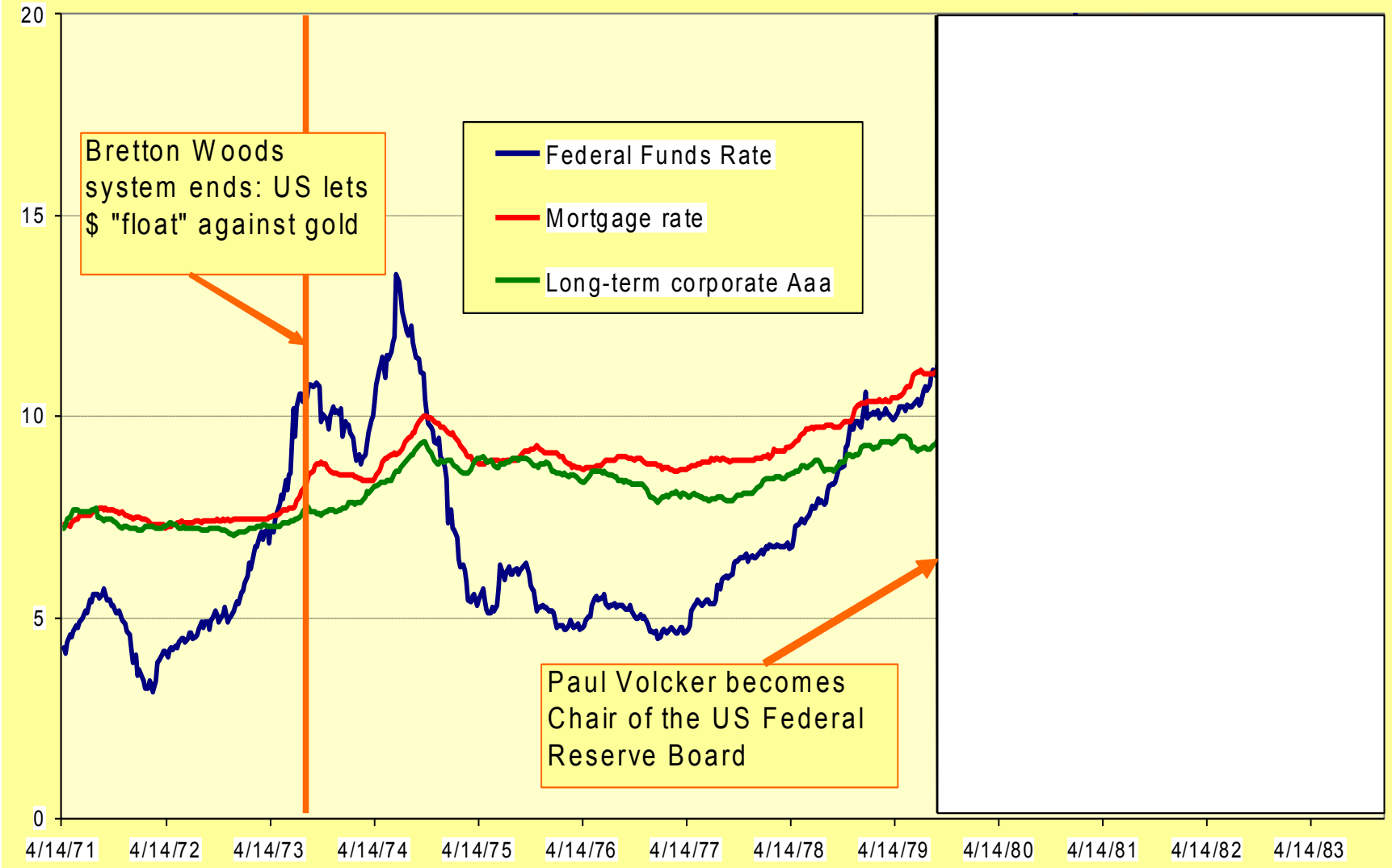
Volcker's Winter 1979 essay in NY Federal Reserve *Economic Review,* "The Political Economy of the Dollar," indicated his plans. He wrote:

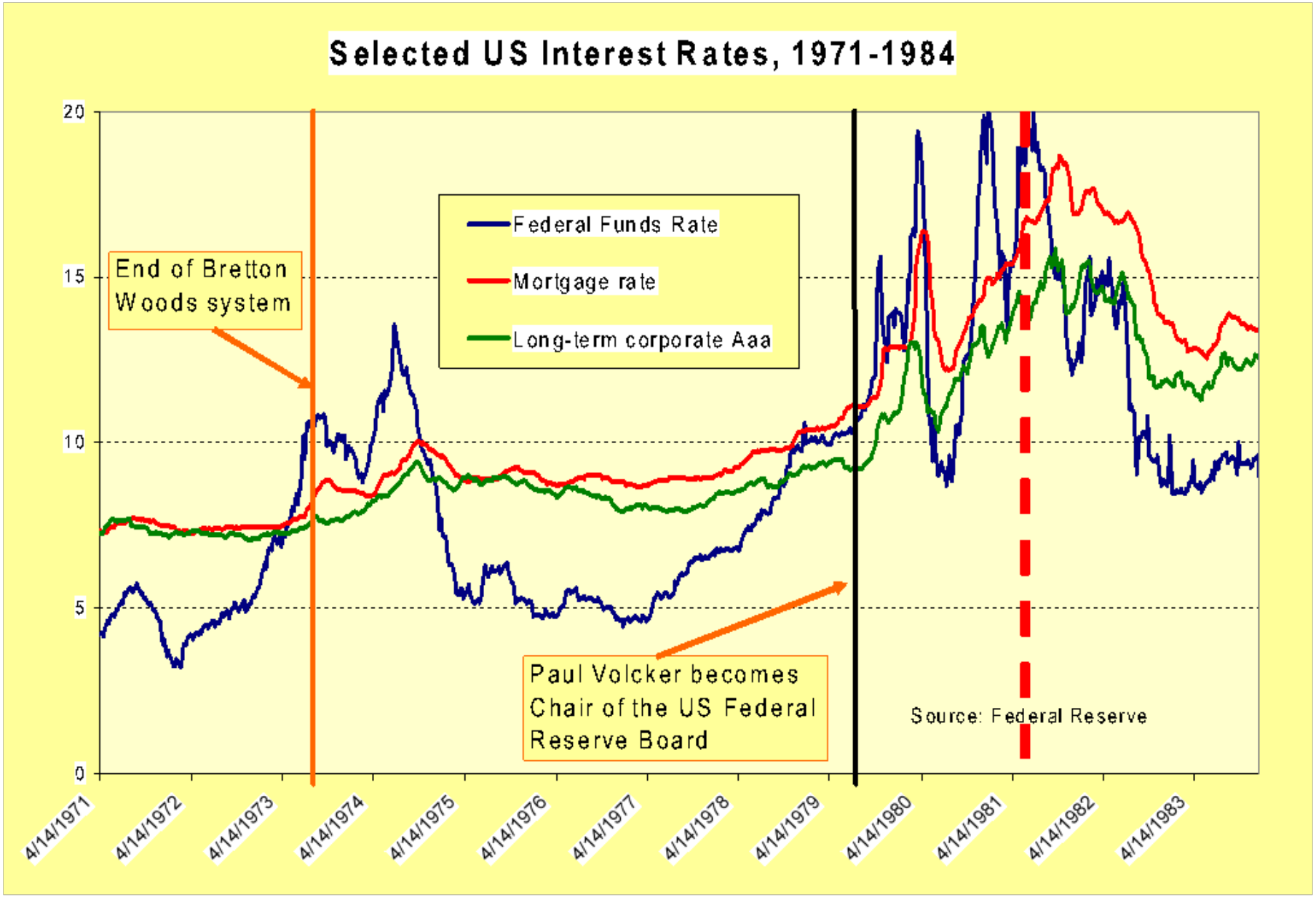
"It is tempting to look at the market as an impartial arbiter .. But balancing the requirements of a stable international system against the desirability of retaining freedom of action for national policy, a number of countries, including the U.S., opted for the latter."

... "a controlled disintegration in the world economy is a legitimate objective for the 1980s."

... “a controlled disintegration in the world economy is a legitimate objective for the 1980s.”

Selected US Interest Rates, 1971-1979




Selected US Interest Rates, 1971-1984
20
15
10
5
0
Federal Funds Rate
Mortgage rate
Long-term corporate Aaa
End of Bretton Woods system
Paul Volcker becomes Chair of the US Federal Reserve Board
Source: Federal Reserve
4/14/1971
4/14/1972
4/14/1973
4/14/1974
4/14/1975
4/14/1976
4/14/1977
4/14/1978
4/14/1979
4/14/1980
4/14/1981
4/14/1982
4/14/1983

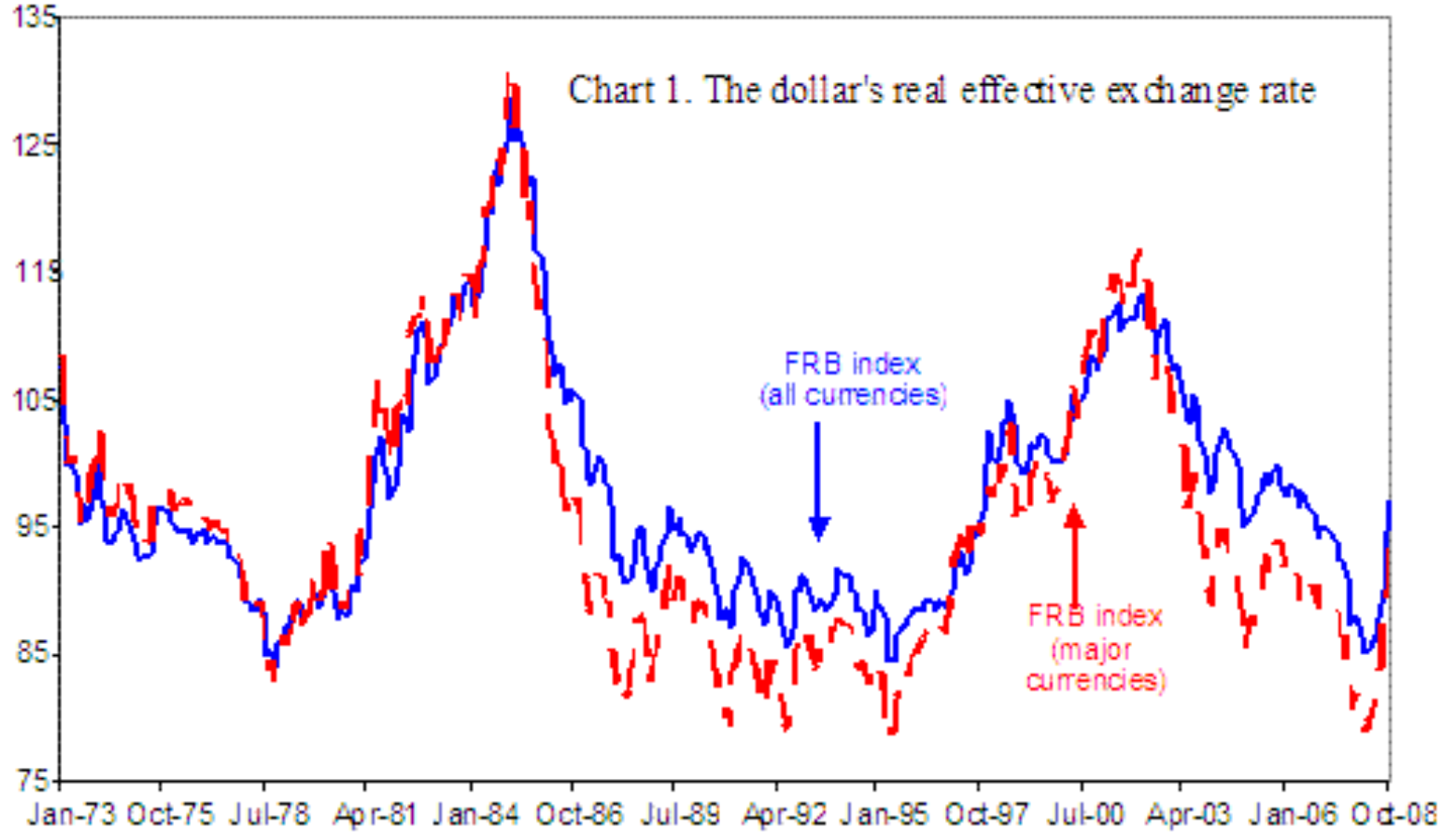


Chart 1. The dollar's real effective exchange rate
135
125
115
105
95
85
75
FRB index
(all currencies)
FRB index
(major
currencies)
Jan-73
Oct-75
Jul-78
Apr-81
Jan-84
Oct-86
Jul-89
Apr-92
Jan-95
Oct-97
Jul-00
Apr-03
Jan-06
Oct-08

6. Minsky's theory of crisis and crisis resolution in historical context

- Minsky's bi-polar vision: "Small government capitalism" vs. "big government capitalism"
- The 1930s vs. the 1960s is his primary contrast.
- In the 1980s, "It" didn't happen again, though "it" could have.
- We learned how to stabilize the unstable economy. Capitalism – investment – was saved.
- Dymski-Pollin: "small" vs. "big" government solutions eroded after the 1980s.
- Crotty: Minsky could find no impediment to sustained economic growth in the real sector of the economy.

Figure 1. Post-Peak U.S. Real GDP Growth:
Small and Big Government and Neoliberal Eras

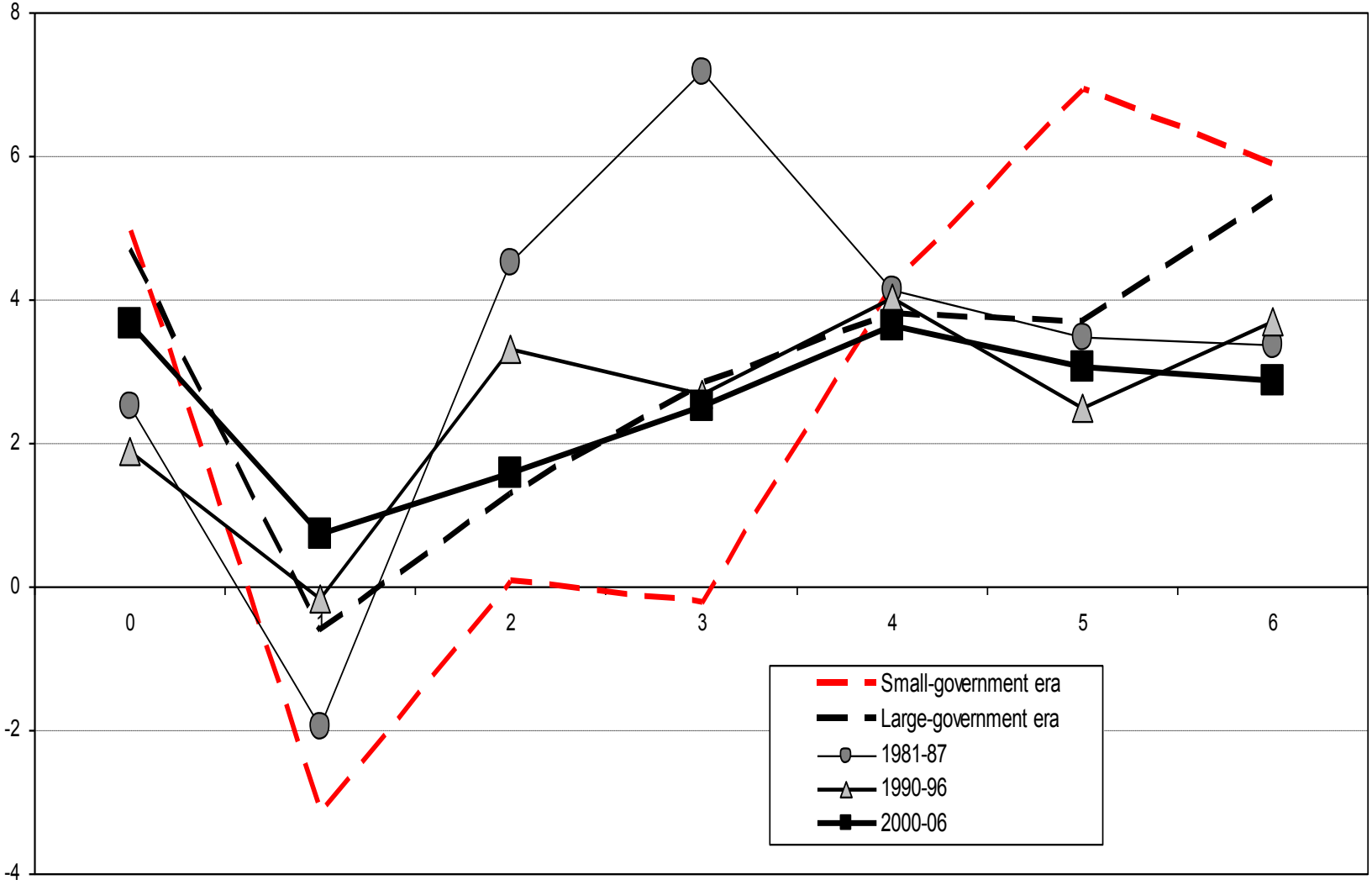


Figure 2. Post-Peak U.S. Unemployment Rate:
Small and Big Government and Neoliberal Eras

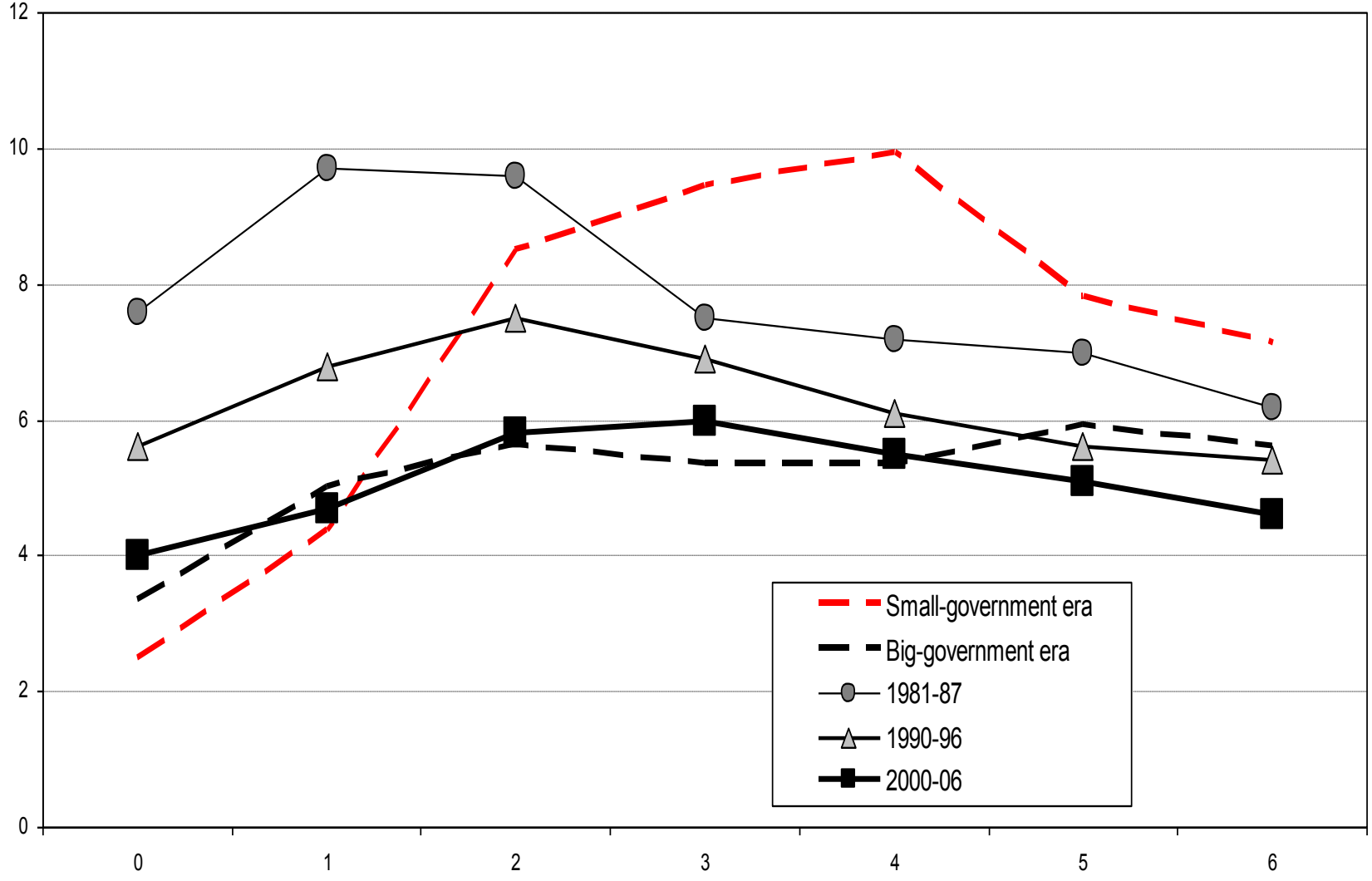
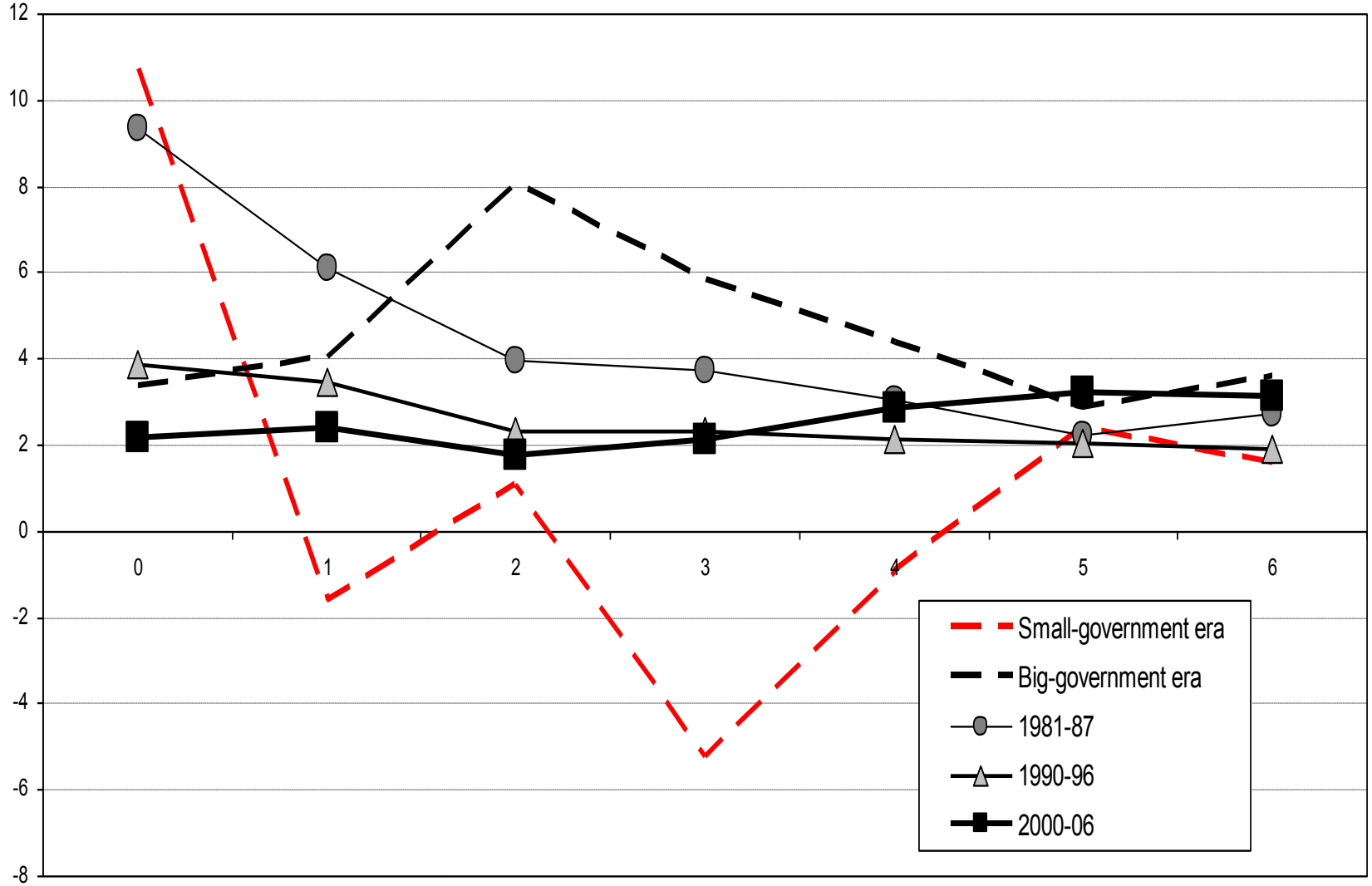


Figure 3. Post-Peak U.S. Price Inflation (Changes in GDP Deflator): Small and Big Government and Neoliberal Eras



The Neoliberal Era: "welcome to the desert of the real"

Dynamics special to the neoliberal era:

- Vastly reduced counter-cyclical government expenditures (SCHIP, anyone?)
- Restoration of the curative powers of crisis on real wage/salary payments
- Restoration of the healing abilities of crisis on the profit rate.

That is, Minsky is too much a hedge-hog. There is no quick-fix. The real sector interacts with, feeds off of, problems/shifts in the financial. Strategic shifts succeed but are self-undermining.

Figure 7. Post-Peak Changes in Real Federal Government Outlays on Individuals: Big Government and Neoliberal Eras (%change per capita)

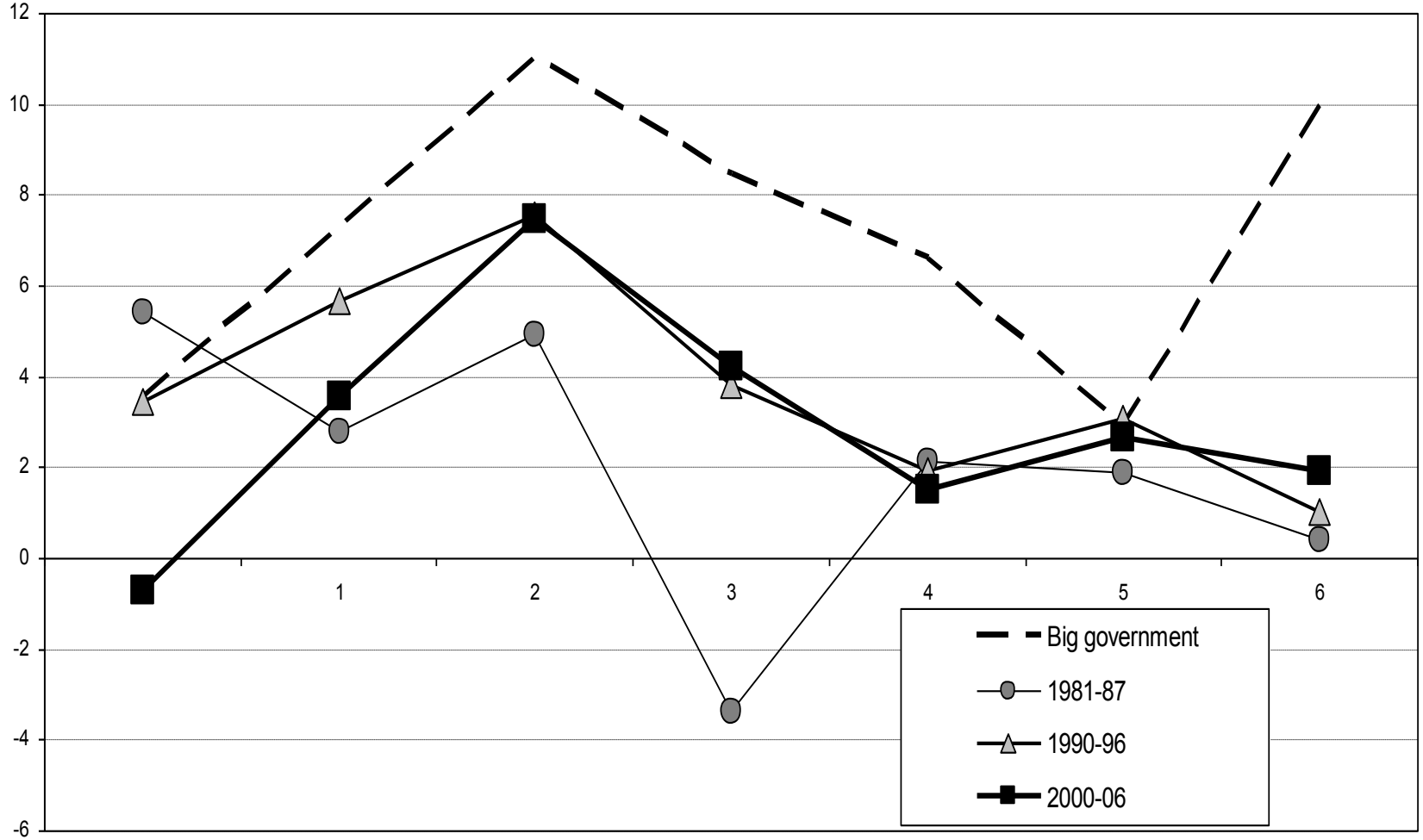


Figure 8. Post-Peak U.S. Real Non-Government Wage and Salary Payments: Big Government and Neoliberal Eras (% change)

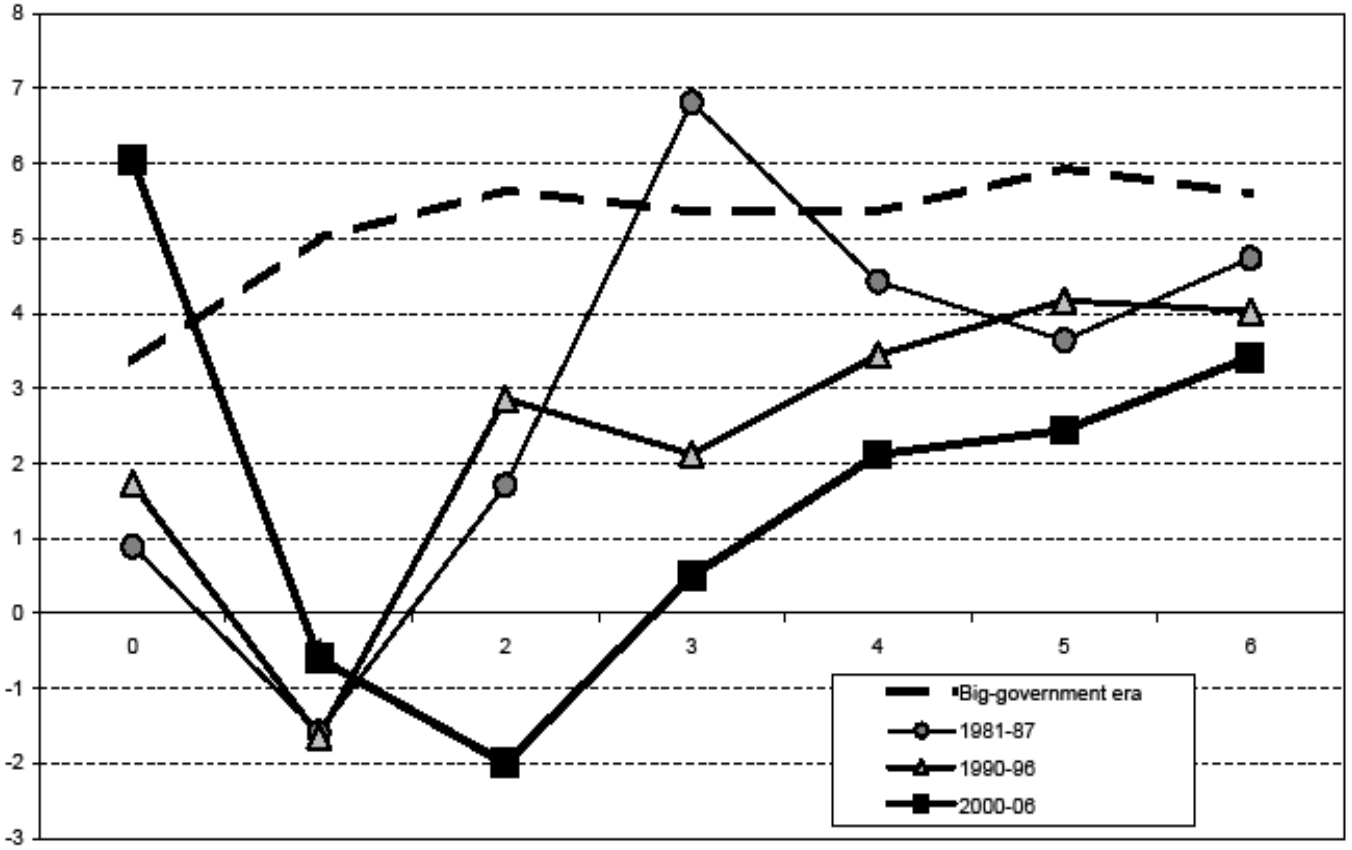
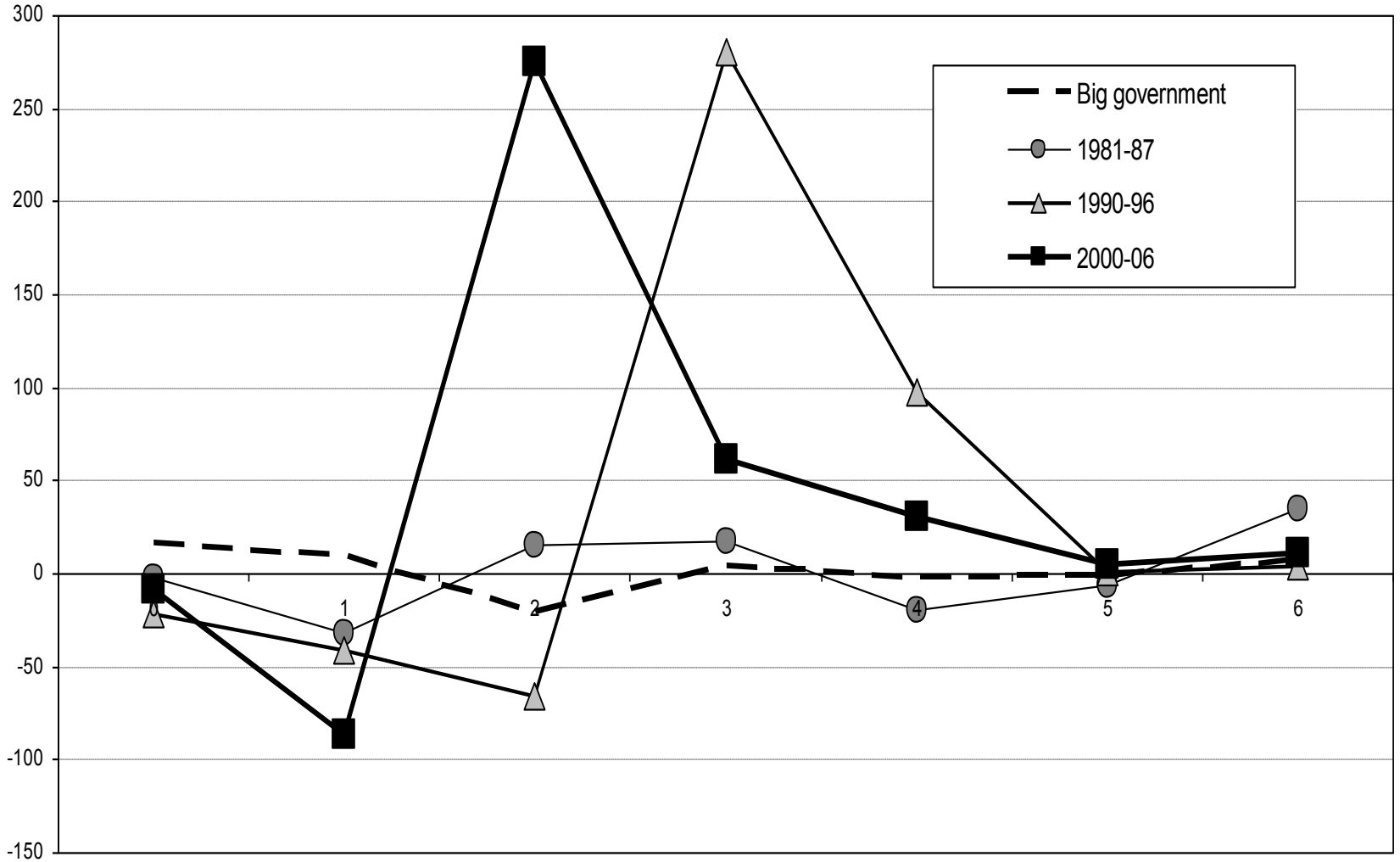


Figure 9. Post-Peak Changes in the Manufacturing Profit Rate:
Big Government and Neoliberal Eras (%Change)



Global Stability and Instability in the Neoliberal Era

- This is not to say that Minsky's focus on financial instability is obsolete. It remains a defining feature of the neoliberal era. But *how* it plays out depends on real-sector factors that *must* be included in a serious crisis theory.
- The latest crisis is rooted in the search for security in the neoliberal world. The US current-account deficit beget steady capital-account inflows to the US, providing credit supply, which permitted the creation of ever more MBSs and SIVs.
- This permitted the creation of mass securitization, and thus shadow banking, and the final escape of finance.