COMMENT (FROM *THE NEW YORKER*)

THE MINSKY MOMENT

by John Cassidy **FEBRUARY 4, 2008**

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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.

Many of Minsky's colleagues regarded his "financial-instability hypothesis," which he first developed in the nineteen-sixties, as radical, if not crackpot. Today, with the subprime crisis seemingly on the verge of metamorphosing into a recession, references to it have become commonplace on financial Web sites and in the reports of Wall Street analysts. Minsky's hypothesis is well worth revisiting. In trying to revive the economy, President Bush and the House have already agreed on the outlines of a "stimulus package," but the first stage in curing any malady is making a correct diagnosis.

Minsky, who died in 1996, at the age of seventy-seven, earned a Ph.D. from Harvard and taught at Brown, Berkeley, and Washington University. He didn't have anything against financial institutions—for many years, he served as a director of the Mark Twain Bank, in St. Louis—but he knew more about how they worked than most deskbound economists. There are basically five stages in Minsky's model of the credit cycle: displacement, boom, euphoria, profit taking, and panic. A displacement occurs when investors get excited about something—an invention, such as the Internet, or a war, or an abrupt change of economic policy. The current cycle began in 2003, with the Fed chief Alan Greenspan's decision to reduce short-term interest rates to one per cent, and an unexpected influx of foreign money, particularly Chinese money, into U.S. Treasury bonds. With the cost of borrowing—mortgage rates, in particular—at historic lows, a speculative real-estate boom quickly developed that was much bigger, in terms of over-all valuation, than the previous bubble in technology stocks.

As a boom leads to euphoria, Minsky said, banks and other commercial lenders extend credit to ever more dubious borrowers, often creating new financial instruments to do the job. During the nineteen-eighties, junk bonds played that role. More recently, it was the securitization of mortgages, which enabled banks to provide home loans without worrying if they would ever be repaid. (Investors who bought the newfangled securities would be left to deal with any defaults.) Then, at the top of the market (in this case, mid-2006), some smart traders start to cash in their profits.

The onset of panic is usually heralded by a dramatic effect: in July, two Bear Stearns hedge funds that had invested heavily in mortgage securities collapsed. Six months and four interest-rate cuts later, Ben Bernanke and his colleagues at the Fed are struggling to contain the bust. Despite last week's rebound, the outlook remains grim. According to Dean Baker, the co-director of the Center for Economic and Policy Research, average house prices are falling nationwide at an annual rate of more than ten per cent, something not seen since before the Second World War. This means that American households are getting poorer at a rate of more than two trillion dollars a year.

It's hard to say exactly how falling house prices will affect the economy, but recent computer simulations carried out by Frederic Mishkin, a governor at the Fed, suggest that, for every dollar the typical American family's housing wealth drops in a year, that family may cut its spending by up to seven cents. Nationwide, that adds up to roughly a hundred and fifty-five billion dollars, which is bigger than President Bush's stimulus package. And it doesn't take into account plunging stock prices, collapsing confidence, and the belated imposition of tighter lending practices—all of which will further restrict economic activity.

In an election year, politicians can't be expected to acknowledge their powerlessness. Nonetheless, it was disheartening to see the Republicans exploiting the current crisis to try to make the President's tax cuts permanent, and the Democrats attempting to pin the economic downturn on the White House. For once, Bush is not to blame. His tax cuts were irresponsible and callously regressive, but they didn't play a significant role in the housing bubble.

If anybody is at fault it is Greenspan, who kept interest rates too low for too long and ignored warnings, some from his own colleagues, about what was happening in the mortgage market. But he wasn't the only one. Between 2003 and 2007, most Americans didn't want to hear about the downside of funds that invest in mortgage-backed securities, or of mortgages that allow lenders to make monthly payments so low that their loan balances sometimes increase. They were busy wondering how much their neighbors had made selling their apartment, scouting real-estate Web sites and going to open houses, and calling up Washington Mutual or Countrywide to see if they could get another home-equity loan. That's the nature of speculative manias: eventually, they draw in almost all of us.

You might think that the best solution is to prevent manias from developing at all, but that requires vigilance. Since the nineteen-eighties, Congress and the executive branch have been conspiring to weaken federal supervision of Wall Street. Perhaps the most fateful step came when, during the Clinton Administration, Greenspan and Robert Rubin, then the Treasury Secretary, championed the abolition of the Glass-Steagall Act of 1933, which was meant to prevent a recurrence of the rampant speculation that preceded the Depression.

The greatest need is for intellectual reappraisal, and a good place to begin is with a statement from a paper co-authored by Minsky that "apt intervention and institutional structures are necessary for market economies to be successful." Rather than waging old debates about tax cuts versus spending increases, policymakers ought to be discussing how to reform the financial system so that it serves the rest of the economy, instead of feeding off it and destabilizing it. Among the problems at hand: how to restructure Wall Street remuneration packages that encourage excessive risk-taking; restrict irresponsible lending without shutting out creditworthy borrowers; help victims of predatory practices without bailing out irresponsible lenders; and hold ratings agencies accountable for their assessments. These are complex issues, with few easy solutions, but that's what makes them interesting. As Minsky believed, "Economies evolve, and so, too, must economic policy." ♦