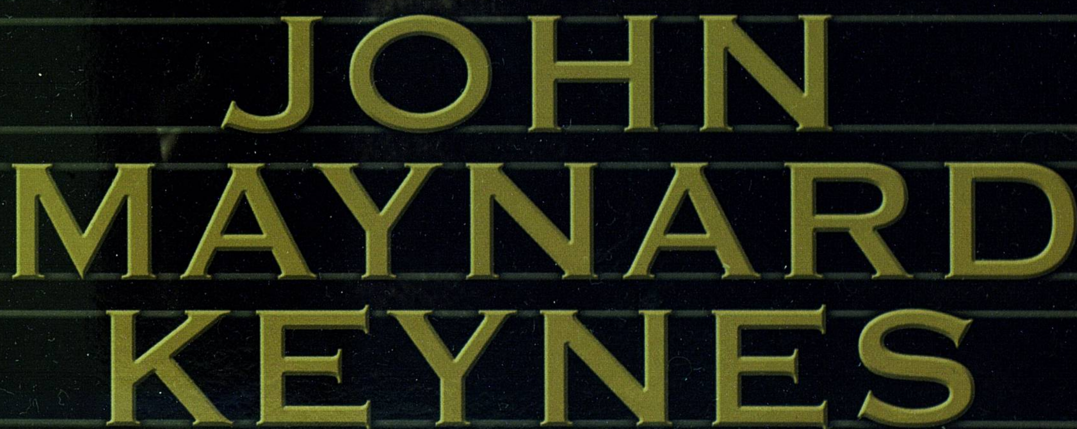
"If you still don't quite understand what happened to the housing market over the last few years and are confused about the late 1990s tech stock bust, you need to read Hyman Minsky's *John Maynard Keynes*."
—Robert Barbera, chief economist, Investment Technology Group



JOHN MAYNARD KEYNES

HYMAN P. MINSKY'S INFLUENTIAL RE-INTERPRETATION OF THE KEYNESIAN REVOLUTION

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Hyman P. Minsky

The Author of *Stabilizing an Unstable Economy*

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John Maynard Keynes

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PREFACE

The missing step in the standard Keynesian theory [is] the explicit consideration of capitalist finance within a cyclical and speculative context... finance sets the pace for the economy. As recovery approaches full employment... soothsayers will proclaim that the business cycle has been banished [and] debts can be taken on... But in truth neither the boom, nor the debt deflation... and certainly not a recovery can go on forever. Each state nurtures forces that lead to its own destruction.

So wrote Hyman Minsky some thirty years ago. As Minsky sketched out this reinterpretation of *The General Theory of Employment, Interest and Money*, mainstream economics was in the midst of rejecting much of the Keynesian thesis that had dominated thinking in the early postwar years. The new wave in academia swung backward, returning to classical economic conceits that embraced the infallibility of markets. Minsky's twin assertions, that capitalism was flawed and that governmental commitment to financial system rescue was essential to avoid ghastly outcomes seemed, in the mid-1970s, to be exactly at odds with the world around him. In Academia, the 1976 Nobel Prize was awarded to Milton Friedman, the modern day poster child for unfettered markets. Soon thereafter, in 1979, Paul Volcker committed the U.S. Federal Reserve to money supply targets, seemingly embracing a zero discretion approach to central banking. And the dominant school of thought, over the 1970s and 1980s, continued new classical pursuits. What began as a reattachment to monetarism morphed into rational expectations and finally became a theory of real business cycles. These new classical nostrums provided successively more elaborate and mathematically sophisticated demonstrations meant to celebrate market efficiencies and keep governments out of the activist economic policy game.

In stark contrast, Minsky, in this monograph and throughout his life's work, steadfastly embraced Keynes's belief in the need for an activist government hand. That said, the most powerful trait Minsky shared with

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Keynes was that neither of them were Keynesians. Minsky, in like fashion with Keynes, strenuously resisted reducing his thesis to an exclusively mathematical formulation. In the pages that follow, Minsky makes a compelling argument that Keynesian reductionism, as it spewed out macroeconomic models, omitted critical parts of the *General Theory*. For Minsky, Keynes without uncertainty is something like Hamlet without the Prince. Oncc pervasive uncertainty is given center stage, models that confidently determine outcomes seem quaint.

Minsky refused to downplay the world's unpredictable nature in order to reduce his vision to a set of equations. As a consequence, he received limited attention in Academia. And yet, in the land of economic practitioners, Minsky's work has generated a growing list of admirers. The reason is simple. Since Minsky wrote *John Maynard Keynes*, financial system fissures followed by dramatic Federal Reserve Board responses have been all too common phenomena. On six separate occasions, in the last thirty years, Fed policy makers have confronted financial system crises and have rescued swooning asset markets with aggressive interest rate ease. Thus from the vantage point of Wall Street, Main Street and the Federal Reserve Board developments over the past thirty years can be described as eerily in line with Minsky's model of the world. Small wonder that a growing number of real world economists label episodes of financial system mayhem Minsky moments.

Minsky's analysis, to be sure, seemed at best irrelevant and at worst antithetical to the forceful change in U.S. monetary policy that began in the late 1970s. Steadfast central bank commitment to low inflation in the U.S. dramatically shrank inflationary pressures and reduced the amplitudes of U.S. boom and bust cycles. Once the U.S. economy was stripped of violent wage and price swings, however, the dynamics of asset market cycles became all the more apparent. Ironically, Minsky's financial instability hypothesis is all the more applicable amid the low inflation and mild recession backdrop that has been in place over the past twenty years.

In the world of forecasting and policy making, economic practitioners have had to make sense of a succession of market upheavals: the banking crisis of the early 1980s, the 1987 stock market crash, the S&L crisis of the early 1990s, the Long-Term Capital Management meltdown, the spectacular technology boom and bust dynamic and most recently the unprecedented rise and then swoon in U.S. residential real estate.

All of these events involved wild changes in expectations about future economic prospects that led to swooning asset values and the inescapable need for Federal Reserve Board rescue. Each involved the spectacle of

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rational men and women, in nearly an instant, radically reversing their collective opinions. A six month swing from enthusiasm to horror for Latin American debt, stocks, junk bonds, technology share prices and finally home values? A growing number of economic practitioners balk at the implausible new-classical economics explanation for these swoons—that fundamental real economy circumstances simply changed. Minsky's framework, presented as a restatement of Keynes, offers instead, a powerful dissection of the U.S. boom and bust cycle, one that depends critically on expectations in a world of pervasive uncertainty. Anyone who is curious about the dynamics that set off the 1990s technology bubble and the mid-2000s slide for U.S. home prices need look no further than the pages that follow.

For Minsky, periodic leaps from serenity to fear are guaranteed in a capitalist economy. What about the promise of a not too hot, not too cold, Goldilocks trajectory? One of Minsky's great insights was his anticipation of the paradox of Goldilocks. Benign real economy circumstances, Minsky observed, invite increasingly aggressive financial market wagers. Innovation in finance, to leverage the promised returns of a Goldilocks backdrop, is a signature development in a capitalist economy. Once leveraged wagers are in place, small disappointments can have exaggerated consequences.

Thus, in Minsky's construct, extended periods of economic calm engender increasing financial system fragility. Boom and bust cycles, in Minsky's vision, are guaranteed by the interactions of the myriad of players who meet and deal on Wall Street. Overzealous central bankers, in Minsky's world, are not the primary cause of business cycles. Quite the contrary, central bank rescues are absolutely necessary to prevent periodic recessions from devolving into debt deflation induced depressions. And shocks from changes outside the normal performance of an economy are not necessary to produce a boom and bust cycle. Instead, predictable steps taken by financiers, bankers, entrepreneurs and investors set in place a dynamic that is categorically cyclical in nature.

Where did Minsky come out on economic philosophy? In the final chapter of this monograph, Hyman Minsky shifts emphasis. No longer simply a diagnostician, Minsky offers up radical prescriptions that he asserts are necessary to both avoid deep recessions and to ensure equitable outcomes for U.S. households. Minsky, with an eye toward economic stability and social equity, championed a move toward socializing investment. Unfortunately, Minsky's radically interventionist recommendations wave a red flag that no doubt has reduced the attention he deserves as a diagnostician. To be sure, many of Minsky's most devoted followers entirely embrace his call to activist, government-directed investment, and warn of an apocalyptic

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end if such steps are not taken. But no heavy lifting is needed to separate diagnosis from prescription. More to the point, even if you believe that economic successes over the past thirty years preclude the need for radical change, keep reading! Minsky's monograph offers up important insights to even the most unabashed free market champions.

Minsky's greatest insight, in the tradition of his thesis advisor Joseph Schumpeter, is that periodic violent plunges arc an inescapable part of the capitalist growth story. Minsky simply expands upon Schumpeter's central observation about creative destruction, linking it to the world of finance. Free market boosters, echoing Schumpeter's sentiments, contend that capitalist finance does the best job of allocating the resources of a society. They point to the experience of socialized investment in the former Eastern bloc, with its waste, inefficiency and ultimately, indifference to the needs of its citizenry. Nonetheless, when market forces move capital, in an uncertain world, Minsky makes it clear that economic calamity is a genuine risk. How then might free market boosters reconcile their views with the Minsky diagnosis? Enlightened capitalists acknowledge that monetary policy activism turns out to be indispensable. A free hand at the central bank is absolutely needed, as the antidote to the last measure of foolish optimism that all cycles deliver. For those who remain convinced that free markets generally deliver the goods, it is a small price to pay to keep the game going.

To be sure, Hyman Minsky believed that inescapable episodes of severe financial instability justified a substantial overhaul of economic policy, one that increased the role of the State. On that score, the last thirty years moved largely in the opposite direction. Over the past decade, however, no one in the world of business and finance can have missed the fantastic rise in focus on and concern about asset bubbles. And that focus catapults Minksy's analysis to the forefront. How much will the U.S. change its policies in response to concerns about financial system instability? That remains to be seen. But in increasing numbers, economists and policy makers now accept two notions. Asset market upheavals come with the territory in a capitalist system. And sharp swings in asset markets drive real economy boom and bust cycles. In other words, mainstream economists and policy makers, perhaps unwittingly but in growing numbers, sound like devoted acolytes of Hyman Minsky.

Robert J. Barbera

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INTRODUCTION

Hyman "Hy" Minsky was uncomfortable with mainstream economics. At the same time, he was drawn to the broader aspect of the discipline that focused on structural, social and political issues. Minsky started out as a student of mathematics but switched to economics after attending the integrated social science sequence course, which was distinctive to the University of Chicago's undergraduate curriculum during the presidency of Robert Maynard Hutchins. The appeal of economics was reinforced by the lectures and seminars taught by Oscar Lange, Paul Douglas, Frank Knight and Henry Simmon, all faculty at the University of Chicago. Minsky did graduate work in economics at Harvard where he was awarded the Masters in Public Administration in 1947 and with interruptions by a number of years in the U.S. Army, he received his Ph.D. from Harvard in 1954.

In his Ph.D. dissertation, Minsky explored the relationships between market structure, financing investment, the survival of firms, aggregate demand, and business cycle performance. He developed these themes and they became the focus of his lifelong research. He taught economics at Carnegie Tech (now Carnegie Mellon University) and Brown University. From 1957 to 1965, he taught economics at the University of California, Berkeley.

At Berkeley, he sharpened his ideas and theories about financial innovation and the importance of the initial condition of financial positions that would determine the future of the economy. Minsky noted that robust corporate balance sheets over time would become fragile, resulting in economic conditions that might deflate debt, leading to a repeat of the 1930s. His views were laid out in this book, (1975) and in *Stabilizing an Unstable Economy* (1986). From 1965 until his retirement in 1990, he was a professor of economics at Washington University in St. Louis. He was then appointed

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Distinguished Scholar at the Levy Economics Institute of Bard College, a post he held until his death in 1996.

In this volume, Hyman Minsky reclaimed the central ideas of J.M. Keynes's *General Theory* (GT) from the bastardization by the neoclassical synthesis. By the early 1970s, that version of Keynesian economics was already falling out of favor—soon to be replaced by ever more extreme versions of the neoclassical orthodoxy that Keynes had attempted to vanquish in 1936. Keynesian policy no longer seemed to work. Soon after Minsky's book was published, the U.S. and other developed economies faced the twin threats of high unemployment and high inflation—stagflation—and the orthodox Keynesians had nothing to offer to policy makers.

Minsky had already, for many years, been predicting that the Keynesian policies adopted after WWII would fuel inflation and rising financial instability. He had warned that the apparent economic stability of the early postwar period would encourage structural change that would make the system more vulnerable to crises. After 1970, the chickens came home to roost with a vengeance. In this book, Minsky presented his first thorough and systematic analysis of what went wrong.

According to Minsky, the problem did not lie in Keynes's theory, but rather in the interpretation of Keynes that tried to synthesize his revolutionary approach to economics with the old neoclassical approach. Because this was not possible, all of Keynes's revolutionary elements were excluded from the synthesis. While Keynes had argued that capitalism is fundamentally flawed, the neoclassical synthesis viewed the capitalist economy as an equilibrium- seeking system subject to relatively minor external shocks that could be offset by policy. Whereas Keynes saw the Great Depression as a normal result of the operation of a financially complex capitalist system, the neoclassical synthesis presumed it was a special case that resulted from an unusual coincidence of shocks and policy errors. While Keynes called for fundamental change, the advocates of the neoclassical synthesis believed minor tweaks and fine-tuning were sufficient. Keynes called his theory "general" but those advocating the neoclassical synthesis reduced it to the special case theory of Depression economics. And while analysis based on Keynes's theory would recognize the apparent tranquility of the postwar boom as temporary, the Keynesians who espoused the neoclassical synthesis proclaimed the end of the business cycle.

How could Keynes's self-styled followers have gone so far astray? According to Minsky, part of the problem was due to Keynes's exposition in the General Theory. While that book represented a sharp break from his earlier *Treatise on Money*, in one important respect it was inferior. The

two volumes of the *Treatise on Money* provided an institutionally detailed analysis of money and financial markets, although—as Keynes recognized it had no theory of the determination of the volume of investment, output, and employment. As Keynes admitted in the General Theory, his earlier work had conflated the price of debts (the interest rate) with the return on capital (the marginal efficiency of capital). Hence, the General Theory corrected his error by presenting a coherent *general* theory of the determination of investment and thus of employment and output.

However, the institutional detail contained in the *Treatise on Money* was dropped. The General Theory does not really tell us how the investment is financed; other than a very brief treatment of lender's and borrower's risk as well as the colorful criticism of the operation of the stock market in Chapter 12, Keynes is mostly silent on the topic. One of the tasks of Minsky's book, then, is to bring investment finance back into Keynes's analysis. It is here that we find Minsky's most detailed exposition of the theory of investment, based on a resurrection of the treatment of the financial system that must implicitly underlie Keynes's General Theory. By bringing capitalist finance back into the analysis, Minsky restores the revolutionary analysis of Keynes.

The General Theory's Chapter 24 famously enumerates the "fundamental flaws" of the capitalist economy: an arbitrary and excessively unequal distribution of income, and an inability to achieve and maintain full employment. Keynes calls for the euthanasia of the rentier, meaning a decrease in capital's share of total income and for socialization of investment. He would drive both the "pure" (risk-free) interest rate and the marginal efficiency of capital toward zero, eliminate the scarcity of capital, and achieve full employment. At the hands of the neoclassical synthesizers, Keynes's proposals were reduced to little more than promotion of private investment to maintain economic growth so that income might trickle down to the poor. Rather than eliminating the rentier, private debt and interest income would grow on trend. Rather than reducing inequality, public policy actually promoted it. Rather than achieving full employment through job creation, policy offered welfare and Social Security to remove people from the labor force. As Minsky argued from the late 1950s, this combination of policies would inevitably promote inflation, rising inequality, and financial fragility.

Keynesians who believed in the neoclassical synthesis celebrated the early postwar economy as the crowning achievement of their policy recommendations as they announced the end of the business cycle. However, Minsky saw that period as a temporary and highly unusual situation. Ironically, the

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robust financial situation that existed at the end of WWII was the unique and special condition in which capitalist finance could be ignored. The private sector was full of safe and liquid government bonds that had resulted from WWII's massive budget deficits. Pent-up consumer demand was unleashed. The Cold War guaranteed government demand for industrial output. Big unions and big business conspired to raise wages of skilled workers and prices of the output of firms with market power. The U.S. dominance of world trade ensured demand for the dollar, and for U.S. output and dollar denominated assets. In these conditions, downturns were shallow and brief, and financial crises were unlikely. When the first postwar financial crisis finally did happen—in the 1966 municipal bond market disruption—it was easily resolved by quick intervention. But Minsky saw that the relative stability would not last because the fundamental flaws of capitalism had not been banished.

In Chapter 24 of the General Theory, Keynes neglected to list a third fundamental flaw of capitalism: financial instability. And it is this flaw that would inevitably bring an end to the "Keynesian" era of the early postwar period. Indeed, the neoclassical synthesis Keynesian policies actually created conditions that made instability more virulent. According to Minsky, these policies lent an inflationary bias to the economy, encouraged debt, and increased income inequality. As a result, deeper recessions and more frequent and severe financial crises would reappear in the 1970s. Minsky was famous for asking, "Can It happen again?"—that is, could another debt deflation and Great Depression occur? His answer was that the combination of Big Bank (Federal Reserve) and Big Government (a federal budget that had grown from less than 3% of the economy in 1929 to more than a fifth of the economy in the postwar period) would be able to prevent "It." His most comprehensive treatment would come later, in his 1986 *Stabilizing an Unstable Economy.* As he would say, "stability is destabilizing." While there is no final solution to this fundamental flaw of the capitalist economy, the instability could be constrained by appropriate institutions and interventions. Unfortunately, the set of policies adopted by the neoclassical synthesis Keynesians made matters worse. It is doubly unfortunate that these policies were identified as Keynesian, helped to discredit Keynes's General Theory, and lead to a resurrection of neoclassical economics.

According to Minsky, even as the General Theory was abandoned, it became more relevant than ever when instability returned at the end of the 1960s. In this volume, he provides the alternative treatment of the General Theory that focuses on cycles and capitalist finance. His is a "financial theory of investment and an investment theory of the cycle." Investment

must be financed, and how it is financed makes a difference. As the portion of investment that is externally financed grows, fragility increases. However, leveraging by using external funds increases profits so long as things go well. In a run of good times, such as those experienced in the early postwar period, most undertakings are successful. This encourages greater leverage, and margins of safety are reduced as the value of liquidity in such a period declines. Financial relations become more complex, with more layers of debt are interposed between income generation and income receipt. If one debtor defaults, a snowball of defaults can result since each creditor is also a debtor to some other creditor—and so on up through a long chain of commitments. To the extent that the institutional structure and swift intervention can constrain the crisis, risky financial practices are validated and still riskier innovations are encouraged. Fragility will rise on a long-term trend, with increasingly severe financial crises. If deep recessions can be avoided, the system is never cleansed of excessive debt—what Minsky termed "financial simplification" that used to occur in depressions, when all debt is wiped out and only equity ownership remains.

As we prepare this new edition of Minsky's famous book, the U.S. and world economies face yet another financial crisis that began in the American home mortgage subprime market, but has since spread to other sectors and financial instruments and far beyond U.S. borders. We cannot know where it will lead, but it will probably be contained before "It" happens again. We also cannot know whether this crisis will cause economists and policy makers to revisit Keynes's General Theory.

What we do know, however, is that interest in Minsky's work has reached an all-time peak. The current crisis has been called a "Minsky Moment" even in the popular media. There is a growing recognition that while the various New Deal reforms had shown their age, a point made repeatedly by Minsky in the 1980s and 1990s, it was foolish to simply dispense with these reforms. Instead, new institutions and methods of constraining private sector practices which actually increase fragility have to be created. A movement to re-regulate the financial system by the U.S Congress is already afoot. The extreme claims of neoclassical economics have been rejected as people realize that a modern capitalist system is not necessarily equilibrium-seeking. Government is called upon—again—to rise to the task of rescuing the economy from the excesses of Neoconservatism. Minsky would find humor and hope in this.

Minsky was always certain that it was possible to "move the discipline" of economics. Like Keynes, he believed in the power of ideas. He insisted that it was a mistake to adopt the neoclassical synthesis version of Keynes

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ECONOMICS

"Today, Mr. Minsky's view [of economics] is more relevant than ever."

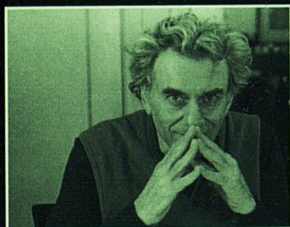
–The New York Times

"Indeed, the Minsky moment has become a fashionable catch phrase on Wall Street."

–The Wall Street Journal

John Maynard Keynes offers a timely reconsideration of the work of the revered economics icon. Hyman Minsky argues that what most economists consider Keynesian economics is at odds with the major points of Keynes's *The General Theory of Employment, Interest, and Money*. Keynes and Minsky refuse to ignore pervasive uncertainty. Once uncertainty is given center stage, recurring financial crises are all but inescapable. As Robert Barbera notes in a new preface, "Benign economic circumstances…invite increasingly aggressive financial market wagers. Once leveraged wagers are in place, small disappointments can have exaggerated consequences." Thus, for Minsky, economic calm on Main Street engenders financial system fragility which, in turn, ensures a perpetuation of boom and bust cycles.

Minsky colleagues Dimitri B. Papadimitriou and L. Randall Wray write in a new introduction: "We offer this new edition, in the hope that it will contribute to the reformation of economic theory so that it can address the world in which we actually live—the world that was always the topic of Minsky's analysis."



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Hyman P. Minsky, Ph.D. was the first to explain how uncertainty, risk, and financial markets drive the economy. He was a distinguished scholar at The Levy Economics Institute of Bard College, and taught at Washington University for 25 years.

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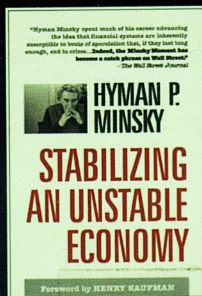

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