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Why capitalism fails

The man who saw the meltdown coming had another troubling insight: it will happen again

By Stephen Mihm, Globe Correspondent | September 13, 2009

Since the global financial system started unraveling in dramatic fashion two years ago, distinguished economists have suffered a crisis of their own. Ivy League professors who had trumpeted the dawn of a new era of stability have scrambled to explain how, exactly, the worst financial crisis since the Great Depression had ambushed their entire profession.

Amid the hand-wringing and the self-flagellation, a few more cerebral commentators started to speak about the arrival of a “Minsky moment,” and a growing number of insiders began to warn of a coming “Minsky meltdown.”

“Minsky” was shorthand for Hyman Minsky, a hitherto obscure macroeconomist who died over a decade ago. Many economists had never heard of him when the crisis struck, and he remains a shadowy figure in the profession. But lately he has begun emerging as perhaps the most prescient big-picture thinker about what, exactly, we are going through. A contrarian amid the conformity of postwar America, an expert in the then-unfashionable subfields of finance and crisis, Minsky was one economist who saw what was coming. He predicted, decades ago, almost exactly the kind of meltdown that recently hammered the global economy.

In recent months Minsky’s star has only risen. Nobel Prize-winning economists talk about incorporating his insights, and copies of his books are back in print and selling well. He’s gone from being a nearly forgotten figure to a key player in the debate over how to fix the financial system.

But if Minsky was as right as he seems to have been, the news is not exactly encouraging. He believed in capitalism, but also believed it had almost a genetic weakness. Modern finance, he argued, was far from the stabilizing force that mainstream economics portrayed: rather, it was a system that created the illusion of stability while simultaneously creating the conditions for an inevitable and dramatic collapse.

In other words, the one person who foresaw the crisis also believed that our whole financial system contains the seeds of its own destruction. “Instability,” he wrote, “is an inherent and inescapable flaw of capitalism.”

Minsky’s vision might have been dark, but he was not a fatalist; he believed it was possible to craft policies that could blunt the collateral damage caused by financial crises. But with a growing number of economists eager to declare the recession over, and the crisis itself apparently behind us, these policies may prove as discomforting as the theories that prompted them in the first place. Indeed, as economists re-embrace Minsky's prophetic insights, it is far from clear that they're ready to reckon with the full implications of what he saw.

In an ideal world, a profession dedicated to the study of capitalism would be as freewheeling and innovative as its ostensible subject. But economics has often been subject to powerful orthodoxies, and never more so than when Minsky arrived on the scene.

That orthodoxy, born in the years after World War II, was known as the neoclassical synthesis. The older belief in a self-regulating, self-stabilizing free market had selectively absorbed a few insights from John Maynard Keynes, the great economist of the 1930s who wrote extensively of the ways that capitalism might fail to maintain full employment. Most economists still believed that free-market capitalism was a fundamentally stable basis for an economy, though thanks to Keynes, some now acknowledged that government might under certain circumstances play a role in keeping the economy - and employment - on an even keel.

Economists like Paul Samuelson became the public face of the new establishment; he and others at a handful of top universities became deeply influential in Washington. In theory, Minsky could have been an academic star in this new establishment: Like Samuelson, he earned his doctorate in economics at Harvard University, where he studied with legendary Austrian economist Joseph Schumpeter, as well as future Nobel laureate Wassily Leontief.

But Minsky was cut from different cloth than many of the other big names. The descendent of immigrants from Minsk, in modern-day Belarus, Minsky was a red-diaper baby, the son of Menshevik socialists. While most economists spent the 1950s and 1960s toiling over mathematical models, Minsky pursued research on poverty, hardly the hottest subfield of economics. With long, wild, white hair, Minsky was closer to the counterculture than to mainstream economics. He was, recalls the economist L. Randall Wray, a former student, a "character."

So while his colleagues from graduate school went on to win Nobel prizes and rise to the top of academia, Minsky languished. He drifted from Brown to Berkeley and eventually to Washington University. Indeed, many economists weren't even aware of his work. One assessment of Minsky published in 1997 simply noted that his "work has not had a major influence in the macroeconomic discussions of the last thirty years."

Yet he was busy. In addition to poverty, Minsky began to delve into the field of finance, which despite its seeming importance had no place in the theories formulated by Samuelson and others. He also began to ask a simple, if disturbing question: "Can 'it' happen again?" - where "it" was, like Harry Potter's nemesis Voldemort, the thing that could not be named: the Great Depression.

In his writings, Minsky looked to his intellectual hero, Keynes, arguably the greatest economist of the 20th century. But where most economists drew a single, simplistic lesson from Keynes - that government could step in and micromanage the economy, smooth out the business cycle, and keep things on an even keel - Minsky had no interest in what he and a handful of other dissident economists came to call “bastard Keynesianism.”

Instead, Minsky drew his own, far darker, lessons from Keynes’s landmark writings, which dealt not only with the problem of unemployment, but with money and banking. Although Keynes had never stated this explicitly, Minsky argued that Keynes’s collective work amounted to a powerful argument that capitalism was by its very nature unstable and prone to collapse. Far from trending toward some magical state of equilibrium, capitalism would inevitably do the opposite. It would lurch over a cliff.

This insight bore the stamp of his advisor Joseph Schumpeter, the noted Austrian economist now famous for documenting capitalism’s ceaseless process of “creative destruction.” But Minsky spent more time thinking about destruction than creation. In doing so, he formulated an intriguing theory: not only was capitalism prone to collapse, he argued, it was precisely its periods of economic stability that would set the stage for monumental crises.

Minsky called his idea the “Financial Instability Hypothesis.” In the wake of a depression, he noted, financial institutions are extraordinarily conservative, as are businesses. With the borrowers and the lenders who fuel the economy all steering clear of high-risk deals, things go smoothly: loans are almost always paid on time, businesses generally succeed, and everyone does well. That success, however, inevitably encourages borrowers and lenders to take on more risk in the reasonable hope of making more money. As Minsky observed, “Success breeds a disregard of the possibility of failure.”

As people forget that failure is a possibility, a “euphoric economy” eventually develops, fueled by the rise of far riskier borrowers - what he called speculative borrowers, those whose income would cover interest payments but not the principal; and those he called “Ponzi borrowers,” those whose income could cover neither, and could only pay their bills by borrowing still further. As these latter categories grew, the overall economy would shift from a conservative but profitable environment to a much more freewheeling system dominated by players whose survival depended not on sound business plans, but on borrowed money and freely available credit.

Once that kind of economy had developed, any panic could wreck the market. The failure of a single firm, for example, or the revelation of a staggering fraud could trigger fear and a sudden, economy-wide attempt to shed debt. This watershed moment - what was later dubbed the “Minsky moment” - would create an environment deeply inhospitable to all borrowers. The speculators and Ponzi borrowers would collapse first, as they lost access to the credit they needed to survive. Even the more stable players might find themselves unable to pay their debt without selling off assets; their forced sales would send asset prices spiraling downward, and inevitably, the entire rickety financial edifice would start to collapse. Businesses would falter, and the crisis would spill over to the “real” economy that depended on the now-collapsing financial system.

From the 1960s onward, Minsky elaborated on this hypothesis. At the time he believed that this shift was already underway: postwar stability, financial innovation, and the receding memory of the Great Depression were gradually setting the stage for a crisis of epic proportions. Most of what he had to say fell on deaf ears. The 1960s were an era of solid growth, and although the economic stagnation of the 1970s was a blow to mainstream neo-Keynesian economics, it did not send policymakers scurrying to Minsky. Instead, a new free market fundamentalism took root: government was the problem, not the solution.

Moreover, the new dogma coincided with a remarkable era of stability. The period from the late 1980s onward has been dubbed the “Great Moderation,” a time of shallow recessions and great resilience among most major industrial economies. Things had never been more stable. The likelihood that “it” could happen again now seemed laughable.

Yet throughout this period, the financial system - not the economy, but finance as an industry - was growing by leaps and bounds. Minsky spent the last years of his life, in the early 1990s, warning of the dangers of securitization and other forms of financial innovation, but few economists listened. Nor did they pay attention to consumers’ and companies’ growing dependence on debt, and the growing use of leverage within the financial system.

By the end of the 20th century, the financial system that Minsky had warned about had materialized, complete with speculative borrowers, Ponzi borrowers, and precious few of the conservative borrowers who were the bedrock of a truly stable economy. Over decades, we really had forgotten the meaning of risk. When storied financial firms started to fall, sending shockwaves through the “real” economy, his predictions started to look a lot like a road map.

“This wasn’t a Minsky moment,” explains Randall Wray. “It was a Minsky half-century.”

Minsky is now all the rage. A year ago, an influential Financial Times columnist confided to readers that rereading Minsky’s 1986 “masterpiece” - “Stabilizing an Unstable Economy” - “helped clear my mind on this crisis.” Others joined the chorus. Earlier this year, two economic heavyweights - Paul Krugman and Brad DeLong - both tipped their hats to him in public forums. Indeed, the Nobel Prize-winning Krugman titled one of the Robbins lectures at the London School of Economics “The Night They Re-read Minsky.”

Today most economists, it’s safe to say, are probably reading Minsky for the first time, trying to fit his unconventional insights into the theoretical scaffolding of their profession. If Minsky were alive today, he would no doubt applaud this belated acknowledgment, even if it has come at a terrible cost. As he once wryly observed, “There is nothing wrong with macroeconomics that another depression [won’t] cure.”

But does Minsky’s work offer us any practical help? If capitalism is inherently self-destructive and unstable - never mind that it produces inequality and unemployment, as Keynes had observed - now what?

After spending his life warning of the perils of the complacency that comes with stability - and having it fall on deaf ears - Minsky was understandably pessimistic about the ability to short-circuit the tragic cycle of boom and bust. But he did believe that much could be done to ameliorate the damage.

To prevent the Minsky moment from becoming a national calamity, part of his solution (which was shared with other economists) was to have the Federal Reserve - what he liked to call the "Big Bank" - step into the breach and act as a lender of last resort to firms under siege. By throwing lines of liquidity to foundering firms, the Federal Reserve could break the cycle and stabilize the financial system. It failed to do so during the Great Depression, when it stood by and let a banking crisis spiral out of control. This time, under the leadership of Ben Bernanke - like Minsky, a scholar of the Depression - it took a very different approach, becoming a lender of last resort to everything from hedge funds to investment banks to money market funds.

Minsky's other solution, however, was considerably more radical and less palatable politically. The preferred mainstream tactic for pulling the economy out of a crisis was - and is - based on the Keynesian notion of "priming the pump" by sending money that will employ lots of high-skilled, unionized labor - by building a new high-speed train line, for example.

Minsky, however, argued for a "bubble-up" approach, sending money to the poor and unskilled first. The government - or what he liked to call "Big Government" - should become the "employer of last resort," he said, offering a job to anyone who wanted one at a set minimum wage. It would be paid to workers who would supply child care, clean streets, and provide services that would give taxpayers a visible return on their dollars. In being available to everyone, it would be even more ambitious than the New Deal, sharply reducing the welfare rolls by guaranteeing a job for anyone who was able to work. Such a program would not only help the poor and unskilled, he believed, but would put a floor beneath everyone else's wages too, preventing salaries of more skilled workers from falling too precipitously, and sending benefits up the socioeconomic ladder.

While economists may be acknowledging some of Minsky's points on financial instability, it's safe to say that even liberal policymakers are still a long way from thinking about such an expanded role for the American government. If nothing else, an expensive full-employment program would veer far too close to socialism for the comfort of politicians. For his part, Wray thinks that the critics are apt to misunderstand Minsky. "He saw these ideas as perfectly consistent with capitalism," says Wray. "They would make capitalism better."

But not perfect. Indeed, if there's anything to be drawn from Minsky's collected work, it's that perfection, like stability and equilibrium, are mirages. Minsky did not share his profession's quaint belief that everything could be reduced to a tidy model, or a pat theory. His was a kind of existential economics: capitalism, like life itself, is difficult, even tragic. "There is no simple answer to the problems of our capitalism," wrote Minsky. "There is no solution that can be transformed into a catchy phrase and carried on banners."

It's a sentiment that may limit the extent to which Minsky becomes part of any new orthodoxy. But that's probably how he would have preferred it, believes liberal economist James Galbraith. "I think he would resist being domesticated," says Galbraith. "He spent his career in professional isolation."

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