

Reclaimed by the Mainstream?

Hyman Minsky and the Global Credit Crunch

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Abstract The global credit crunch has brought the name of Hyman Minsky from the shadows of heterodox political economy into the very centre of crisis analyses. The global financial meltdown has been dubbed as a ‘Minsky moment’ in finance, or a crisis of ‘Ponzi finance.’ Does this suggest that financial mainstream has finally realized its intellectual impotence in the face of systemic breakdowns? Has Minsky been rehabilitated completely? This paper aims to answer these questions, by examining the emergent post-crisis policy debate at the international level.

This paper inquires into what seems to be the key ‘Minskyan’ lines in the international regulatory discussion that has followed the global credit crunch. Specifically, I focus on three concepts that inform many Minskyan readings of the credit crunch: the “Minsky moment” in finance; the notion of the paradox of stability, and the role of Ponzi finance in the crisis. The paper aims to establish to what extent the current international policy reflection of these issues has moved beyond the analytical tenets of mainstream financial theory. As I find, the core of Minsky’s political economy – his critique of financial innovation – remains overlooked in the post-crisis debate on the future of financial governance.

Introduction

Hyman Minsky had long been an outsider of mainstream finance and economics. A pessimistic theorist of financial capitalism, he did not fit

into the increasingly technical, equilibrium-centred currents of economics. His timing as an institutionalist of Keynesian tradition was wrong too: the monetarism-dominated 1970s and the 1980s were not a friendly time for a post-Keynesian scholar. In this instance, it seems rather odd that an outcome of the continuing crisis has been to rehabilitate the name of Hyman Minsky – long an outsider of mainstream finance and economics – in the emergent analyses of the crisis. Commentators speak about a “Minsky moment” in the financial system, repeat his wise observation that “stability is always destabilizing” and even note the element of Ponzi pyramids in the recent bout of securitization. But which part of Minsky’s vision of financial instability and economic reform do today’s policymakers pick? And what precisely does a ‘Minskyan’ reading of finance suggest about the current state of the world financial markets?

This paper aims to answer these questions by reviewing the emergent theorisations of the global credit crunch as in what can be considered as the “mainstream” of crisis analytics and policy debate. Specifically, I focus on three Minskyan undertones in crisis theorising: 1) the notion of a “Minsky moment” in the financial cycle; 2) the thesis about destabilising stability, and 3) the crisis of Ponzi finance. To what extent the current considerations of these issues has moved beyond the analytical constraints of neoclassical economics and mainstream financial theory?

Analysing the usages of these concepts imply in the crisis commentary and conceptualisation of the credit crunch, and contrasting these with their wider meaning in the political economy of Minsky, I argue that despite appearances, the core of Minskyan theory of finance still sends a very inconvenient message to today’s believers in financial innovation and competition. As a result, I find that a highly selective and fragmented version of Minsky’s theory of finance is informing the emergent accounts of the credit crunch. Stylised as an end of the North

Atlantic credit boom, in turn aggravated by the usages of specific products and techniques of securitisation the global crisis has not fundamentally compromised the intellectual edifice of efficient market theory of finance (EMT) and its central place in information global policy-making. Minsky's political economy, with its critique of financial innovation in the deregulated credit system, thus remains as outside the "mainstream" of finance, as it was in his own time.

Hyman Minsky and Financialised Capitalism

Rather briefly, and unfairly crudely, Minsky's framework can be summarised as follows. Any capitalist system with an advanced financialised economy goes through cycles and institutions mutations. Regardless of the specific context of these transformations, there is an inherent, embedded conflict in this system – between shifts and rapid changes in the financial system and the state of the real economy (which includes economic stability generally and full employment). This basic conflict is centres on the process of financial innovation and the ability of private financial firms to raise and emit debt as their major form of financing: "...in a capitalist economy that is hospitable to financial innovation, full employment with stable prices cannot be sustained, for within any full-employment situation there are endogenous disequilibrating forces at work that assure the disruption of tranquillity" (Minsky 2008: 199).

This ability to rely on debt and 'invent' money (even temporarily) in turn, triggers a chain of transformations leads to conservative financial units (*hedge* financed unit, where existing obligations and debt commitments are consistently lower than the incoming profit flows) to become more risky (*speculative*, where not all profits flow can cover

existing obligations)) and ultimately, *Ponzi* (where one can only repay old debt by borrowing anew).

This chain of debt-driven developments makes the financial system increasingly fragile, prompting the monetary authorities to intervene in order to prevent a structural economic collapse. Because capitalism is an incredibly diverse and constantly changing system, the resulting instability does not conform to any fixed model; the timing of the financial distress and crisis are almost impossible to identify in advance. Any policy response to financial instability, Minsky argued, should involve both monetary and fiscal measures, since on its own, monetary policy is ineffective: “Monetary policy is of very limited effectiveness both in constraining inflation and in counteracting a depression” (Minsky 1982: 173). Most controversially, Minsky showed that the mechanism that spreads fragility and crisis throughout the system, centres on the complex chain of liquidity-stretching financial innovations that appear to enhance liquidity, but in fact, by replacing state-backed money with privately created financial instruments, make the financial system progressively illiquid.

With his close focus on endogenous process of financial evolution and instability, for most of his own lifetime, Minsky remained a rather eccentric scholar, standing aside from the big intellectual armies of mainstream economics (Strange 1998). It was only in heterodox political economy and more recently, in International Political Economy that Minskyan analysis of financial instability has found not only a grateful audience, but has opened up a niche for a plethora of his intellectual successors. Yet heterodox political economists, however brilliant they might be, are still heterodox: rarely do you see their names on the pages of *Econometrica*, nor are they frequented by the journalists from the *Wall Street Journal* and the *Financial Times*. It is all the more striking therefore, that one result of the global credit meltdown has been to rehabilitate the name of Hyman Minsky from the shadows of critical

political economy, and place his work at the very the centre of crisis commentary. The global credit crunch has been dubbed as a ‘Minsky moment’ in finance, or a crisis of ‘Ponzi finance.’ Does this suggest that financial mainstream has finally realized its intellectual impotence in the face of systemic breakdowns? Has Minsky been rehabilitated completely? I suggest not.

From the “Minsky moment” to a Minskyan crisis?

In the summer of 2007, George Magnus, chief economist of UBS, put the term “Minsky moment”¹ at the centre of crisis analyses when he warned that a financial crisis might soon engulf the US and international financial markets. According to Magnus, a ‘Minsky moment’ is “the point where credit supply starts to dry up, systemic risk emerges and the central bank is obliged to intervene.” (Magnus, 22 July 2007). Back in July 2007, Magnus and other observers believed that such a moment could be averted. We know that it was not.

As a result of the financial turmoil that has ensued, Minsky’s theory of finance has attracted more attention, and references to the ‘Minsky moment’ recur on the pages of financial broadsheets, market commentary and research publications of some bodies responsible for financial governance. (Interestingly, these tend to be EU-based institutions, rather than their US counterparts). Jean Claude Trichet for instance, described a “Minsky moment” as a situation “whereby there is a sudden recognition and recoil from underlying credits whose quality was in fact worsening for years” (Trichet 2008). Searching for

¹ As we will see below, the ownership of the term ‘Minsky Moment’ is in fact claimed by Pimco’s managing director, Paul McCulley.

explanations of the credit crunch, M. Knight, general manager of the BIS, stated:

“The explanation I find most persuasive focuses on...the key features of the recent turmoil: the lack of transparency in the originate-to-distribute model; the role played by credit rating agencies in the evaluation of structured products; and the covert reliance on special purpose vehicles to conduct off-balance sheet financial transactions on a large scale. The effect of all these influences was that when the "Minsky moment" came suddenly last summer, perceptions of risky exposures, both to credit losses and to liquidity shortages, rose sharply, as did uncertainty about where those exposures might materialize” (Knight 2008)

Thus typically in these and similar accounts, a “Minsky moment” describes a situation of a sudden collapse of the financial system, or a critical junction at which governments should intervene. This is not necessarily incorrect in capturing some of Minsky’s message. In his theory of financial crisis, Minsky did argue that “even after money market becomes unstable, the central bank, by monetising the vulnerable asset, can prevent widespread repercussions from occurring” (Minsky 1982: 175). As governments world-wide have scoped up trillions of “toxic” financial assets, and as the central banks have accepted privately issued debts as legitimate collateral in return for bailout lines, a “Minsky moment” has arrived indeed.

At the same time however, references to a “Minsky” moment as a defining feature of the global credit meltdown are somewhat over-manufactured, for two reasons. First, Minsky himself never really focused on any precise “moment.” Rather, he analysed the stages and mechanics of the financial cycle which indeed, can encounter a period, or a factor, of distress that in turn, sends a cascade of destabilising waves throughout the financial system. Second, a “Minsky” moment is only the tip of a much bigger conceptualisation of financial crisis. The centre of his critique of financial capitalism was not a “moment” or factor as such, but the actual processes and dynamics that are able to drive the

financial system towards the critical state of fragility. Therefore in what follows below, I examine the place of the two other Minskyan concepts in emergent conceptualisations of the credit crunch: the paradox of stability, and the role of Ponzi finance.

Destabilising Stability: Cyclical Theories of the Credit Crunch

“Stability is always destabilizing”, Hyman Minsky famously stated in his financial instability hypothesis. It surely is. The global credit crunch came as the end of the more than a decade-long boom in the North Atlantic credit markets. That boom, in turn, paralleled a period of economic expansion, driven by consumption and unprecedented affordability of credit, which led many politicians talk about new economy - defined by a unique combination of low consumer price inflation and falling unemployment rates. Alan Greenspan has dubbed this period a “the new era of active credit management” (in Morris 2008: 61). Amidst the ostensible rehabilitation of Minsky’s work, it is this message about the paradox of stability that seems to dominate most commentaries on the credit crunch:

“The forward Minsky journey, this time around anyway, was the progression of risk-taking in the financial markets represented by the excess of subprime loans, structured investment vehicles (SIVs) and other shady characters inhabiting the shadow banking system. Their apparent stability begat ever-riskier debt arrangements, which begat asset price bubbles. And then the bubbles burst, in something I dubbed (years ago, in fact, when looking back on the Asian credit crisis) a “Minsky Moment.” (McCulley 2009).

According to Minsky (and many others) “good” times breed complacency, exuberance and optimism about one’s position in the market, which leads to heavier reliance on leverage and underestimation of risks. Indeed, as stated famously by Citi’s Chuck Norries in the wake of the subprime fiasco: “When the music stops, in terms of liquidity, things will

be complicated. But as long as the music is playing, you've got to get up and dance" (cited in Soros 2008: 64). Most observers concur that the major factor in the global credit crisis has been the progressive underestimation, or mis-understanding of risks by financial agents based, in turn, on the general sense of stability, economic prosperity and optimistic forecasts that had pervaded North Atlantic economies, creating bearish financial markets and what Soros has called a "super-bubble" of credit.

"The creation of new securities facilitated the large capital inflows from abroad... The trend towards the 'originate and distribute model' ...ultimately led to a decline in lending standards. Financial innovation that had supposedly made the banking system more stable by transferring risk to those most able to bear it led to an unprecedented credit expansion that helped feed the boom in housing prices" (Brunnermeier 2009: 78).

However politically, the origins and longer-term implications of this trend to under-estimate the risks has been viewed differently by different observers. Former US Treasury Secretary Henk Paulson for instance, believes that the root cause of the credit bubble was the "liquidity glut" coming from the emerging markets: "Superabundant savings from fast-growing emerging nations...put downward pressure on risks and yield spreads everywhere...This laid the seeds of the credit bubble that extends far beyond the US subprime mortgage market and now has burst with devastating consequences... (in Guha 2009). A UK-based policy reflection on the lessons of the credit crunch, the so-called Turner review, also stresses the destabilising link between global imbalances and financial advances in the North Atlantic economies: "At the core of the crisis lay an interplay between macro-imbalances which had grown rapidly in the last ten years, and financial market developments and innovations which have been underway for about 30 years but which accelerated over the last ten to 15, partly under the stimulus of the macro-imbalances" (FSA 2009: 11). In this sense, many emergent theories that interpret the

credit crisis in cyclical terms, do appear to have strong undertone in Minsky's analysis of destabilising stability.

Indeed, optimistic expectations about the future of the economy have placated the senses of major economic and financial agents. Stability and good times, just as Minsky wrote, bred complacency, under-estimation of true economic and financial risks, and outright greed and exuberance. According to cyclical theorisations then, the underlying cause of the continuing malaise is the markets' increasing tendency to under-price financial risks during the boom years of 2002-2007. As it is being argued, the booming housing market, the low-inflationary monetary policy (low interest rates and the climate of cheap and easy credit), the constant competitive drive among banks and financial houses for commissions and aggressive techniques of investment, underpinned by expectations of unstoppable rises in the value of real estate, have numbed the financial sector's ability to estimate risks and rewards accurately. This, in turn, has pushed investors into more riskier assets and techniques of trade:

“For almost a year and a half the global financial system has been under extraordinary stress--stress that has now decisively spilled over to the global economy more broadly. The proximate cause of the crisis was the turn of the housing cycle in the United States and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in credit markets. However, although the subprime debacle triggered the crisis, the developments in the U.S. mortgage market were only one aspect of a much larger and more encompassing credit boom... Aspects of this broader credit boom included widespread declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased reliance on complex and opaque credit instruments that proved fragile under stress, and unusually low compensation for risk-taking” (Bernanke, 2009, 13 January).

Generally therefore, ostensibly advancing Minsky's message about the paradox of financial stability, most mainstream commentators on the

crisis tend to diagnose it as a behavioural problem of the market, specific to the most recent financial and economic cycle (2002-2007), and driven fundamentally, by human failure. As states in the Turner review- so far, the most radical, and critical policy reflection on the nature of the credit crunch:

“...it seems likely that some and perhaps much of the structuring and trading activity involved in the complex version of securitised credit, was not required to deliver credit intermediation efficiently. Instead, it achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investors and companies and between companies and individual employees. Wholesale financial services, and in particular that element devoted to securitised credit intermediation and the trading of securitised credit instruments, grew to a size unjustified by the value of its service to the real economy” (FSA 2009: 49).

Interestingly in this instance, the actual diagnoses of why and how financial markets produce bubbles tend to draw on the Minsky-Kindleberger hypothesis of financial instability, sometimes going as far as to challenge the key assumptions of the EMT paradigm (FSA 2009; Trichet 2008; IMF 2008: 20)). As phrased in the 2009 Geneva Report:

“Most financial crises are preceded by asset price bubbles. Bubbles often emerge after financial liberalizations or innovations and can persist since even rational sophisticated investors find it more profitable to ride a bubble rather than to go against it. This is in sharp contrast to efficient market hypothesis, but supported by empirical findings... Herding behaviour among financial institutions which are evaluated against the same benchmark are further contributing factors” (Brunnermeier et al 2009: 30).

To the extent that Minsky’s original framework was a portrayal of a larger financial and business cycle, the theory of destabilizing stability does indeed fit the consensus description of the global credit crunch (as in fact, it fits any analysis of boom and bust waves in financial capitalism).

But it is the nuances of interpretation of this cycle that make a difference. While Charles Kindleberger did indeed stress the element of irrationality in driving financial manias and panics, for Minsky, irrationality has little role to play in Minsky's political economy. Rather, it is the internal mechanism within the liberalised credit system that precipitates fragility and crisis. In Minsky's analysis, fragility is an inherent feature of an advanced financialised economy. At the same time, according to Minsky, instability assumes many guises, and is not caused by human behaviour as such, but by the endogenous dynamics of the financial system driven by financial innovation and competition. It is this message that newly-born Minskyan seem to overlook: emphasising the human factor in causing the crisis, they often view the global credit crunch as an extraordinary episode, or 'moment,' in the otherwise smoothly functioning financial capitalism. In this sense, the crisis hits the markets as one extraordinary, exogenous shock.

Interestingly, protagonists of this view include lawyers who defended the fraudsters of Bear Sterns, politicians of different calibres on both sides of the Atlantic, as well as leading figures of economic policy such as Alan Greenspan. Facing accusations for his direct role in creating the bubble of easy credit during the 1990s and early 2000s Greenspan has termed the crisis a "once-in-a-century phenomenon" (Greenspan, 31 July 2008). Defending Mr Cioffi, one of the Bear Sterns' financiers charged with the nine-count indictment with conspiracy, securities and wire fraud, his lawyer argued: "the credit crisis took everyone by surprise, including the Fed and the Treasury. Dozens of the largest financial institutions in the world have lost over \$300 billion to date on the same investments" (Kelly 2008: 15).

Baffled and incapacitated by the scope of the meltdown, regulators and policy-makers also tend to emphasize the extraordinary character of the crisis and the fact that it had come as shock to most people. In October 2008, Lord Turner, who had just taken over the FSA, noted: "In

April of this year everybody knew that something pretty big had happened to the world's financial system. What we had no idea, bluntly, was how extreme it was going to be..." (Turner, 2008). The Prime Minister, Gordon Brown followed with the same line:

"We tend to think of the sweep of destiny as stretching across many months and years before culminating in decisive moments we call history. But sometimes the reality is that defining moments of history come suddenly and without warning...An economic hurricane has swept the world, creating a crisis of credit and of confidence" (Brown, 4 March 2009).

Therefore, while Minsky's notion of destabilising stability is now informing most emergent theories of the credit crunch, it is disappointing is that this uncontroversial statement has diverted the attention from the core of Minsky's political economy. Specifically, by building up a theory of the credit crunch as the end of the preceding credit boom, commentators and policymakers often chose to focus their analytical and policy responses on either fixing the isolated features of the recent bout of securitisation (for instance, suggesting to re-regulate certain financial products and practices), rather than to confront the actual source of financial fragility and crisis – the political regime of deregulated, privatised credit and the paradigm of welfare-enhancing, risk optimising financial innovation. In Minsky's analysis, treating the crisis as an exogenous shock or a "moment" simply does not make sense. Indeed, the risks unleashed and accentuated by the securitization process, as well as the fragility of the US mortgage market and the economy as a whole had been noted repeatedly by many commentators long before the turmoil began in the summer of 2007. Trouble is, most whistleblowers were dismissed at the time, as in fact, was the very message of Minsky and his followers.

The Crisis of Ponzi finance

From its very start, the credit crunch has been described as the crisis of Ponzi finance. The increasingly popular use of the term, as well as the collapses of financial pyramids of Bernie Madoff and Allen Stanford, has too, put Minsky's model at the centre of crisis analytics. As noted above, to Minsky, "Ponzi" is a method of financing old debt with new debt. In Minsky's original taxonomy, Ponzi finance is a phase in the transformation of the financial cycle; it corresponds to the expansion of the financial innovation spiral and the progressive under-estimation of risk by financial agents, particularly during periods of economic optimism.

Essentially therefore, a Ponzi collapse is a debt crisis: when there is too much debt accumulated by an economic agent, and there is no way to either get the resources to pay the debt (and interest), postpone the payments, or shift the debt on to someone else, economic agents face insolvency. Plain and simple. In the financial system relying on companies' ability to emit debt on the basis of internal risk strategies however, the Ponzi mode has become the way for firms to manipulate, manage and trade a whole variety of financial risks. Structurally, the expansion of new markets for credit instruments, especially in Anglo-Saxon economies, has been underpinned by the policies of cheap credit, or the 'popularisation of finance,' and have made the political regimes on both sides of the Atlantic dependent on the stability and growth of the financial and banking sectors (Montgomerie 2007).

Institutionally, according to Jan Kregel (2007), Ponzi finance is related to the way risk has been valued, assessed, and modelled, by banks and financial houses since the liberalisation reforms were introduced in the 1980s. In the post-Basle spiral of financial innovation, driven by the aggressive search for profits and desire to outperform your competitors, the "old style" prudent banking was derided as boring and

conservative, while the proactive risk-takers were considered sophisticated, innovative and shrewd. As long as this market atmosphere was supported by the belief in robust economic fundamentals, the under-valuation of risks, especially the liquidity risk, the aggressive expansion of new borrowings, and in many cases, the use of quasi-legal investment techniques and outright swindling, flourished. In this element, Kregel notes, the ongoing financial crisis does differ from the context Minsky identified originally, yet the consequences will still be severe: it may still lead to a process of debt deflation and recession.

Debt crises are always destructive, yet aside from the sheer scale of the collapse and uncertainty as to its long-term consequences, there is another crucial, yet so far overlooked, aspect of the current crisis. Ponzi finance, as the label suggests, implies a crucial role of intentional deceit: financing debts with new borrowings is the basic principle of a pure pyramid scheme. In the 1990s post-socialist Europe for instance, many people repeated Carlo Ponzi's fate, and have been imprisoned for fraud through the construction of financial pyramids. The global credit crunch has also raised some uneasy political questions about the role of fraud, corruption and simple negligence in the recent expansion of the credit bubble and the securitisation industry.

Here, when analyzing the workings of the Ponzi principle today, one should not forget that in essence, Ponzi finance is a pyramid scheme, typically - as the allusion to the fraudster Carlo Ponzi implies - containing an element of deception or fraud. The charges against Bernie Madoff and Allen Stanford, as well as a series of money fraud investigations launched by the FBI in the wake of the subprime crisis, illustrates the degree to which financial innovation has helped disguise outright fraud and swindling. What is more worrying however, is that the expansion of the subprime lending in the USA illustrates that Ponzi-type operations reached an industrial scale (Kirchgaessner and Weitzman 2008). None of the policy debates or reform drafts that unfolded in the

wake of the crisis actually addresses this troubling dimension of financial innovation.

Yet even in purely financial terms, the subprime industry was a giant Ponzi scheme. First, the practice of providing people with uncertain credit histories, no prospects of higher incomes and often no jobs, with 100% (or sometimes higher) mortgages, was itself a deception on a very large scale. From the very start it was clear that many of those subprime borrowers would be unable to pay their mortgages if, or rather *when*, the interest rates on their loans rose. Any Ponzi scheme can thrive only as long as it attracts new participants. In the USA, subprime lending was justifiable only by the belief that the rising values of property would suffice to repay the loans, and like in any Ponzi scheme, this belief proved to be self-fulfilling. As Kregel (2008) argues, once the bottom layer of properties was inflated through the creation of massive demand, the entire U.S. housing market entered into a bubble phase. Housing markets, however, are notoriously cyclical. It was this fact, along with the actual terms of the subprime loans that the scores of financial advisers who sold the products, forgot to mention to their clients.

Second, the terms of borrowing and the conditions for repayment appear, in retrospect, to be the key block in the Ponzi pyramid of subprime loans. Ponzi-type methods employed by lending institutions included large pre-payment penalties, low ‘teaser’ rates that reset at much higher rates, knowingly inducing a borrower to loan terms that she will not be able to meet (Wray 2008).² What is more worrying, is that the Ponzi mode seems to have spread far beyond the epicentre of the crisis – the US subprime industry. On the one hand, subprime lending mushroomed in the USA (and to a lesser extent in other Anglo-Saxon

² Kregel notes that often, borrowers were lured in into taking a mortgage on their new home without being told that they would be unable to pre-pay it, to change the terms of the mortgage, and that their interest repayments after the initial ‘teaser’ periods would be up to 6% higher than the market average: in other words, they were simply trapped into the sub-prime net.

countries such as the UK, Australia and New Zealand) due to historically low interest rates in the 1990s and 2000s that presented ample opportunities for borrowers. On the other hand, low interest rates were available in many other regions – notably in continental Europe and Japan - which have avoided the spread of similar Ponzi schemes on the back of their own subprime sector. To me, this suggests that the Ponzi pyramid of subprime finance, and the related securitization boom, had been shaped by the political climate in the Anglo-Saxon economies, and correspondingly, by the benign and ill-informed view of financial and monetary authorities on the risks posed by the expanding bubble of artificial liquidity. Concealed by the plethora of innovative financial techniques and the illusion of liquidity, the process of securitisation has become a giant Ponzi scheme (Nesvetailova 2010).

In this instance, the tale of Northern Rock is particularly revealing. The fall of the British bank shows not only how dangerously interconnected financial markets have become, although this seems to be the lesson most commentaries chose to draw from the Rock's collapse. Much more worryingly, the collapse of the bank revealed that the political regime of deregulated credit and the economic climate requiring companies to come up with ever more sophisticated ways to originate, value, manage and trade risk, actually helps disguise, if not encourage, fraudulent financial practices. Worse, existing regulation of financial innovation helps 'clever' financiers make their frauds seem legitimate.

Two – very problematic - elements behind the Rock's story are relevant in this case. The first is what seems to be pure financial negligence and unaccountability: the management of the Bank has failed to act on the rising riskiness of their financial strategy (Chick 2008). The aggressive over-reliance on the wholesale capital markets for funds amidst the deteriorating credit markets and subprime crisis spreading in the USA, raises a question: Why did Northern Rock continue with this mode of raising finance? One possible answer suggests simple negligence

on the part of the bank's managers. That scenario implies that the crisis of Northern Rock is a one-off phenomenon, it does not represent any systematic trends, because banking crises, essentially, are the problem of the 19th century capitalism. In autumn 2007, this scenario seemed plausible: "no other major lender is in quite the same situation but the banks and building societies that borrow most in the wholesale markets are the most vulnerable."³

In the broader context of the credit meltdown that ensued however, it appears that Northern Rock was one of the many - and certainly not the biggest - examples of companies manipulating financial vehicles and investment techniques. Under the new 'originate and distribute' principle, banks seek to maximize their profits by moving lending to unrelated affiliates, and off their balance sheets (Kregel 2007: 11; Wigan 2009). That implies that seeds of a Minskyan Ponzi crisis stem not from individual undervaluation of risks by financial companies (as simple negligence by Rock's managers would imply), but from the very organisation of risk structures of the credit system as a whole.

While internally, risk-managing models may work well for individual (or even a few) institutions, at a systemic level, common risk strategies contribute to the build-up of fragility, rather than its dispersion. As Avinash Persaud explained back in 2002, "the sophisticated internal risk models require a bank to reduce exposure to risk when the probability of losses increases as a result of falling or more volatile asset prices. If every bank uses these systems, and they have similar positions, and they try to sell assets at the same time, the system enters into a crisis" (Persaud 2002). This reading of the Rock's crisis, and the political economy of the credit crunch as a whole, would, just as Minsky argued back in 1986, a much more radical, and comprehensive,

³ Among these names, commentators mentioned Paragon, UK's biggest buy-to-let lender, Bradford & Bingley, Halifax owner HBOS and Alliance & Leicester (<http://www.guardian.co.uk/business/2007/sep/14/money.northernrock1>). Paragon has since crashed under the effects of the credit crunch.

political response. Individual bailouts, quantitative easing and even temporary nationalisation will not suffice to restore stability, at least not in the long run.

The second problem that has come into light after the Northern Rock crisis relates to deception more closely. Richard Murphy, an independent tax expert, investigated an artificial scheme employed by Northern Rock to disguise nearly £50 billion through the use of a private offshore trust (entitled Granite companies), and a charity based in the North-East of England, whose name was used, presumably, for financial gains and tax evasion purposes, and without its knowledge. The named charity seems to have been entirely unaware of the scheme, having received only one small donation from the Rock's staff in 2001.⁴ (Similar schemes are reportedly common practice among all the major British banks).

The precise ownership structure of Granite companies and its financial relationship with Northern Rock, are murky. Because Granite is a Jersey-incorporated vehicle, and due to the secrecy laws of Jersey (generally considered an offshore financial centre), there is no way of knowing who precisely is the trustee or creditor of Granite. There is a consensus however, that the Jersey-based offshore structure was used as a securitization vehicle for mortgages issued by Northern Rock. It is suspected that Granite served as an equivalent of a price transfer channel for the Rock, a means through which the bank could transfer profits earned in the UK to a near-zero tax regime of Jersey.

As the British Treasury opted to nationalise Northern Rock, the exact relationship between the new owner – the UK government – and Granite, never became clear. The UK government seems to believe that it owns Granite, as well as Northern Rock. Others however, are not sure.⁵ An anonymous source close Granite said that “the obligations on

⁴ Financial Times: Alphaville Blog: “The uncharitable tale of Northern Rock”.

⁵ <http://www.guardian.co.uk/business/2008/feb/21/northernrock.banking>

Northern Rock as an originator of mortgages continue to exist... It is a financial reality.” According to the source, in case Northern Rock stops supplying Granite with mortgages, it would have to pay back the £49 bn owed to its investors.⁶ In the worst case scenario therefore, the British taxpayer may end up paying twice for Northern Rock: first to nationalise it, then second, to honour the Rock’s obligations to Granite, which in turn, may be owned by Northern Rock. Although some British MPs have raised the questions about the precise links between Northern Rock and Granite, but there have been no clear answers.

The scandal of Northern Rock has raised concerns about how many other companies might be benefiting from similar schemes through the use of structured finance and complex investment pyramids. According to the *Financial Times*, lead underwriters on the Granite programme were Lehman Brothers, Merrill Lynch, and UBS; underwriters were Barclays Capital, Citigroup, JP Morgan and Morgan Stanley.⁷

The tale of another big casualty of the credit meltdown, Lehman Brothers, has reiterated the scale of the problem of obscure debt and financial manipulation. The post-crisis investigation of the fallen bank revealed that globally, at the time of collapse, Lehman is estimated to have held \$1.2 million derivatives contracts with a total notional value of \$6 trillion dollars. It held over \$1.2 trillion of open positions spread between almost every market counterparty, all of whom were looking to minimise their exposure to Lehman. Just like in the case of Northern Rock, offshore facilities helped conceal the risks of the transactions. Lehman, and many other banks, accumulated MBAs in one country, securitised them, “sliced and diced” then with other MBSs, then moved the resulting assets overseas, blurring the valuation basis of the original security (Thomson 2009: 9-11). This has not only triggered a liquidity

⁶ <http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=180124&d=1032&h=1024&f=1026>

⁷ FT Alphaville, Blog Archive.

crunch at Lehman, but also has made bankruptcy procedures very difficult.

Altogether, the secrecy and lack of transparency offered by offshore financial centres have facilitated the spread of outright fraudulent or quasi-legal Ponzi schemes, preventing public authorities from adjudicating in cases when private financial manipulation leads to systemic risks and public losses (Palan 2004; Palan *et al.* 2010). Unlike the 1920s America or 1990s Russia, however, the architects of today's Ponzi pyramids are much harder to identify (indeed, it was Madoff himself who came clean about the true scale of his Ponzi pyramid). Ponzi's successors today not only include financial gurus devising models in back offices across the City of London, Wall Street and Cayman Islands; but governments and legislation that allowed the spiral of financial innovation to get out of control.

Therefore, while references to Ponzi schemes of isolated crooks like Madoff and Stanford have hit the headlines, Hyman Minsky again offers a deeper and more disturbing warning to crisis theories today. His message is actually not about these isolated pyramid schemes, but about the level of obscurity modern financial innovation has reached, facilitated by institutional changes in the financial institutions and crucially, permitted by the new paradigm of credit risk management. The current crisis therefore, is not the outcome of one malfunctioning institution, market segment, or contrary to what many believe, a financial model. Rather, it is an outcome of a political-economic and legal regime which has facilitated the privatisation of gains from financial risks, at a cost of socialising their losses. In other words, a regime that had made the Ponzi principle a legitimate and prominent, vehicle of financial innovation.

Conclusion: Minsky's Political Economy and the Global Credit Crunch

Reviewing the emergent mainstream of post-crisis policy response, I conclude therefore that Minsky was partially rehabilitated. His insight into the cyclical nature of financialised capitalism, the endemic financial fragility and the role of leverage seem to have challenged, or at the very least, compromised, the basic tenets of orthodox finance theory. Indeed, even Alan Greenspan accepted that he had been wrong to assume that lending institutions would carry out proper surveillance of their counterparties, confessing that he

“made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own shareholders... I had been going for 40 years with considerable evidence that it was working very well... The whole intellectual edifice, however, collapsed in the summer of last year” (in Beattie and Politi 2008).

Very few of these commentators however, go deeper into the scholarly legacy of Minsky, to challenge what I believe has been the essence of his political economy. Namely, his profound and contentious observation that just as financial innovation marks any period of economic optimism and tranquillity, financial innovation inevitably drives the system towards the brink of a crisis. The mechanism that produces such tendency centres on the myth of liquidity-creating financial innovation. It is disappointing that amidst emerging critique of self-regulating finance and attempts to gain a better understanding of liquidity itself, this part of Minsky’s message seems to have been ignored.

The G20 Plan for a strengthening the global financial system for instance, is disappointingly reminiscent of its rather impotent predecessor - the brief attempt to erect a New International Financial Architecture (NIFA) in the wake of the late 1990s crisis. As stressed in the G20 Communiqué: “Regulators and supervisors must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope for regulatory arbitrage,

support competition and dynamism, and keep pace with innovation in the marketplace” (G20 2009; paragraph 14). The authors of the Geneva report are even more certain about the ultimately beneficial role of financial innovation: “Our preference is for light-touch regulation (with one exception on housing loan-to-value ratios...). In general, restrictive control of financial intermediation stifles innovation and, especially if government starts to intervene with direct controls over bank lending, interferes with the appropriate allocation of capital” (Brunnermeier et al 2009: 10).

Thus while noting the risk-valuing consequences of the general macroeconomic environment and investor expectations, most mainstream analysts of the crisis have opted to overlook the core of Minsky’s framework. Especially once we consider the contentious issue of “liquidity” in the crisis, it appears that only a fragmented, and highly selective, version of Minsky’s theory of finance resonates in current readings of the meltdown. Very few of them, indeed, cast a critical eye on the very ability of financial intermediaries to stretch the frontier of private liquidity, ultimately accentuating financial fragility in the system and thus accelerating the scope for a structural financial collapse and economic crisis.

In this sense, with the global credit meltdown, the “Minsky” moment has arrived indeed. Partly, it is a moment of delight to his intellectual followers and students of political economy; partly it is a moment that accentuated the depth of his critique of financial capitalism. Indeed, amidst the euphoria about the resurrection of his work, let us not forget the message of the political economy of Minsky. It is not so much about Ponzi finance, and certainly not about a ‘moment’ in the financial development. It is rather, his serious warning about the inherent conflict, embedded in a highly financialised economy, between the vagaries of financial innovation and economic stability generally. Despite the scale of the global meltdown – incidentally, foreseen by many

Minskyans – this insight, it appears, remains far too controversial for the academic and policy orthodoxy in contemporary finance.

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