

A MINSKY MOMENT? THE SUBPRIME CRISIS AND THE 'NEW' CAPITALISM

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Introduction

It would be impossible to understand today's capitalism and what has been happening in the European Union, outside a global macroeconomic framework which includes the United States and Asia. The subprime crisis which erupted during the Summer of 2007 and is spreading throughout the world financial markets, seems to confirm some of our earlier interpretations based on the trinity formed by traumatized workers, by indebted consumers, and by manic-depressive savers (Bellofiore and Halevi 2008). These aspects must in turn be set in the context of the policies pursued in the present regime of financialized capitalism where labour itself is subsumed under finance and debt. The dimension of this phenomenon will become clearer when we will elucidate the mechanism of investing by asset stripping through leveraged buy-out operations. Hence, we will begin with a reasoned historical account of the subprime crisis. We will then raise the issue of the 'Minsky moment' and how it can be placed in the present context.

An outline of the emergence of the crisis

“Derivatives” are financial contracts stipulating an exchange based on the guess regarding the future value of a particular financial asset. Formally these are instruments aimed at hedging against risk. There can be as many derivatives as there are guesses and attributes regarding the assets concerned (Bryan and Rafferty, 2006). Since derivatives are just a piece of paper they can be multiplied and issued in relation to other derivatives

as well. The big push, as once Harry Magdoff and Paul Sweezy explained to us, started in the first half of the 1980s with the expansion of contracts on futures and with derived contracts on the future of those futures. It is clear therefore that instead of hedging against risk, derivatives and the like are essentially speculative activities aiming at making profits on future incomes bypassing production altogether. This casino-type activity, instead of protecting against risk, actually expands it to every corner of the economy. In this context the subprime crisis gives us a very good perspective on the dynamics of today's capitalism. It has, indeed, highlighted that the deadly combination of derivatives with other financial "innovations" transformed markets into an unprecedented minefield.

It is remarkable how, more than 8 months after the eruption of the subprime crisis, new and unheard of financial papers keep surfacing as worthless. This crisis was well announced and yet it is still impossible to determine its depth and ramifications. The problems with the speculative credit bubble became evident around March 2007 with an exceptional rise in housing repossessions, with a fall in real estate values and with sudden and sharp falls in the New York and Shanghai stock exchanges. Underneath all this was the contradiction between reality and the belief the financial Ocean would remain calm. And, as we know from Keynes, capitalists love to take risk only when they firmly believe that they will not be hit by a storm before cashing in.

The belief that the Ocean would stay calm was fuelled by the means used to stave off stagnation employed by two countries for about two decades: the United States and Japan. These are both the two largest economies in the world and the most interconnected. For reasons going back to the reconstruction of Japan's capitalism, supported by the United States after 1945, Japan is hooked onto the USA. In 1987 with the October 9 Wall Street crash, Japan very quickly reflatd its economy by sharply reducing the interest rate charged by the Central Bank, thereby flooding with money both itself and the American financial markets. That move turned out to be crucial to refuel the liquidity starved US stock exchange system but it also created a speculative bubble of gigantic proportions in Japan. The bubble was pricked by Tokyo's government in 1992 (through an increase in interest rates) which feared a clash between the speculative overheating of the economy and its exports dynamics. But in capitalist systems economic policies seldom achieve their stated objectives. The bubble was pricked and the economy collapsed into a state of deep stagnation with the yen rising till 1995. To avoid a true depression the Japanese government reduced interest rates to about zero and pumped a large amount of money expanding the budget deficit to nearly 10% of GDP.

These hyper Keynesian policies, while preventing Japan from sinking into a depression, did not restart growth. Instead they opened up the way to the so called yen carry trade. It became quite logical for both Japanese and foreign banks and financial companies to borrow in Japan in yens at insignificant interest rates, and "invest" the money in higher yielding securities and stocks in the USA. The Japanese crisis on one hand, and the US response to its own stagnation tendency on the other, became mutually compatible through the carry trade in yen.

In the United States the solution to the stagnation tendency was found in the twin process of indebtedness and financialization. The latter became the main factor directing investment in real plant and equipment. Indeed throughout the 1980s and the 1990s, aside from the military industrial sector, the productive branches servicing the financial sectors grew most and absorbed an increasing share of real investment. Present day financial processes and mechanisms stem from indebtedness which gathered momentum since the late 1970s. Initially it was made mostly by company debts, while becoming in the course of time increasingly determined by households' debt (Magdoff and Sweezy, 1977; Chesnais 2004). Terms like "securitization", describing offerings of titles to sustain private debt, or hedge funds, companies specializing in risk management, appear in the United States with increasing frequency from the late 1970s onward. In that decade US capitalism was caught in a very serious stagnationist crisis determined by the (a) the end of the Vietnam War, (b) the Starts agreements with the USSR which capped the level of nuclear arsenals and of their vectors, (c) the ousting of the Shah in Iran which dented another major source of military procurements and directly affected the US oil-finance network (Ferguson and Rogers, 1986). For debt creation to become the offsetting factor of the stagnationist deadlock, institutional space had to be created in the first place.

To put the matter into its historical perspective we must mention that both in the second half of the 1950s and throughout the 1960s heavy fluctuations in the stock exchange affected neither policy decisions nor evaluations regarding future real investment. The Dow Jones index, for instance, was 700 in 1963 and just 750 in 1969 but with intermediate peaks around 1000 points, i.e. it displayed a volatility nearing 50%. Yet these fluctuations were within a closed circuit, as it were, since the banking system was insulated from the stock market because of the legislation passed during the Roosevelt era. The real economy and the profitability of both industry and finance were, instead, propelled by the spending policies induced by the Vietnam War. With the onset of stagnation in the 1970s the political and economic response gravitated towards the transformation of debt into a source of financial rents and of support to effective demand through household indebtedness. In this context, throughout the 1980s and 1990s the required institutional space was created by abolishing the safeguard provisions of the Roosevelt era and by changing pensions' financial flows from funds tied to specific entitlements into funds available for financial markets in which benefits came to depend upon market capitalization.

The institutional expansion of the space for debt creation transformed the preoccupation with stagnation into a belief that financial markets would show a systemic tendency validating expectations concerning future capitalization. But this 'confidence' was essentially the by-product of governmental activities centred on injecting liquidity internationally. Such policies began with the Wall Street crash of 1987, were expanded during the 1990s, and acquired unprecedented proportions with the war in Afghanistan and in Iraq after 2001 and 2003. It is this kind of public money that sustained the fireworks of private moneys and the growth of the derivative markets. Without government created liquidity, the implementation of the large private financial operations of the last decade – from investments into junk bonds to private equity take-overs – would have been much more problematical, if at all possible. This Ocean of State injected liquidity has had a

twofold effect. On one hand it has increased speculation and the volatility that goes with it. On the other hand, however, it has augmented the capacity to absorb the said volatility. Hence the ingrained belief in the sustainability of an ever growing financialization of the economy. Although there have been instances of financial bankruptcies with many victims, no chain event occurred on a scale to shatter the above mentioned belief. That was mostly due to the continuing issuance of liquidity by the public authorities. The explosion of the dotcom bubble in 2000 began to shatter that credence but the swift transformation of American monetary policies into a new form of war financing in 2001 (De Cecco, 2007), created the conditions for the absorption of the many bankruptcies leading to the impression that the Ocean would remain essentially calm.

During the first quarter of 2007 the financial castle began to crumble. The weak points were no longer inside the financial institutions, something that could be addressed by further expanding liquidity. The real weaknesses came from the terminal points, from the inability of customers to service their mortgages. In February two major companies – Nova Star and New Century Financial specializing in the subprime market - went under. By May the storm had crossed the Atlantic hitting the Swiss UBS which was compelled to close down its hedge fund Dillon Read because of a 91 million euros loss in the subprime market. It was a major signal that hedge funds could no longer pass the risk onto somebody else. It showed that by multiplying operations aimed at hedging against risk, the latter ends up being propagated like a virus rather than dispersed and minimized. An outcome that was contrary to what economists and managers alike wanted the public to believe.

That was just the beginning. The true terminal points, i.e. the inability of customers to pay, surfaced on the 19th of June when two hedge funds belonging to the investment bank Bear Stearns announced that they would try to recover moneys by repossessing insolvent debtors' assets and valuables. This event is what made the fall of debris into a massive relentless landslide that – to date – is yet to be stopped. Uncertainty driven near panic situations began to spread throughout financial companies and banks on both sides of the Atlantic. A major reason for the heightened fear lay precisely in the way each subprime crisis erupted. In every case, that is, in each of the debt packages involved, there were securities hitherto deemed perfectly safe and now fully contaminated. Hence each case highlighted the fact that it was impossible to pinpoint the source of risk. Financial experts could not differentiate between valuable and worthless securities. Thus every single form of debt capital became contaminated, so that confidence was being withdrawn not just from the bundles of real estate securities, but also from equity - highly leveraged - capital. In July equity companies became unable to raise the funds needed to acquire the auto group Chrysler, dumped by the German Daimler, and Alliance Boots. In August the sale of Virgin Media was also suspended. All the above were leveraged buyout operations (LBO).

The phoney nature of the new finance

LBOs are acquisitions of companies based on debt. The Italian dictionary *Garzanti Linguistica* gives a very clear definition of this kind of activity: “acquisitions of companies by means of purchase of their shares financed by issuing debt guaranteed by the purchased shares”. Such debt becomes a tax deductible cost and is extinguished with the net proceeds obtained by selling the restructured, and usually split, companies back to the markets. The restructuring of real companies by means of debt occurs also through corporate raiders, the nature of which had been lucidly depicted, when still in its infancy, in the movie “Pretty Woman”. These are financial companies which, after raising money, raid firms which are under financial stress. Their objective is to drastically restructure and split them, betting on phenomenal increases in the value of their shares. These operations contain no technological innovations or search for new markets. They involve decisions concerned purely with the expulsion of the labour force. The corporate raider does not necessarily have to buy all the shares of a company. The latter procedure is, instead, preferred by the private investment funds. They raise debt capital to buy all the stocks, by offering stockholders a price above the ruling one. The acquired company is then taken off the stock market. Equity investment funds, themselves a conglomerate of financial companies, necessitate a great deal of debt which is then shouldered by the companies they have “bought”. In other words, the equity investment fund tax deducts the debt from its own balance sheet, but that very debt is the reference figure to gauge financial success. Its profitability, this time outside the stock exchange, is calculated net of the existing debt incurred in the buyout process.

Equity investment funds operate in the short period; seldom on the basis of production results, which take a much longer time horizon. Therefore the profitability sought by the private equity fund has got nothing to do with either Classical-Marxian or Kaleckian profitability. It can only come from cost cutting, thereby affecting wages and employment, and from rent seeking operations. Asset stripping becomes a central part of the working of equity investment funds. In effect profitability is replaced by the revaluation of the operating assets of the company, which is undertaken by junking the least profitable branches. The US-Japanese tidal wave of liquidity allowed for a big expansion of equity investment operations especially in the light of the parallel wave of industrial relocation, outsourcing and subcontracting which opened the door to the disembodiment of the different components of a company. By bypassing the stock market, while keeping the short term notion of capital gains of financial markets, equity funds operate with precise financial objectives aimed at eventually selling the asset stripped companies. Having cashed in, the equity fund will continue elsewhere its pirate run. Never mind that the successfully sold companies lose all productive coherence, their “success” being in fact an imputed one. That is, imputed and construed by the entire financial superstructure on which the equity funds itself rests, such as multinational accounting firms, credit rating agencies and so on. The validation is never in terms of production and technical efficiency. In reality the success of the sold companies is measured in terms of their capacity to attract further debt instruments and leveraged operations and not on their engineering and technological capabilities.

In the United States the transformation of the pension system from defined benefits to defined contributions, where benefits depend on capitalization, led to pension funds to be heavily involved in both hedge and equity funds. Under the new financialized capitalist regime a true bonanza set in, especially in regards to expectations of future capital gains, while risk could be “dispersed” via the multiplication of derivatives. Purchases could be organized via intermediaries through the capital markets, the liquidity of which relied in essence on public moneys; while debt payments could be made with a gain, through asset stripping, restructuring etc. That is, through the sacrificing of workers, the real objects of the restructuring operations. LBOs contributed to the explosion of mergers and acquisitions and to stock price inflation. Contrary to the ideology that portrays the Anglo-Saxon financial system more stock exchange and less banking orientated as compared to, say, the German one, banks were the main financing agents of LBOs. Banks also owned a great deal of hedge funds supposedly operating in the capital markets as non bank institutions.

As a consequence, when the whole system of grabbing today future values began to unravel in 2007, banks found themselves exposed in two intertwined ways. Since under the new capitalist regime, lending meant also investing in collaterals in off-balance sheet operations (to circumvent the capital requirements set by the Basle II agreements), banks ended up holding securities of uncertain and, indeed, of vanishing value. These securities were the major component of collaterals used to raise money for LBOs operations, which became immediately affected by the subprime crisis. However, the largest component of overall lending takes place at the interbank level. Banks’ confidence in each other’s position depends on the assets they hold. These are mostly financial assets defined by the very same securities the content of which was increasingly showing up as hollow. Hence what initially was deemed as a liquidity crisis, appeared by early September 2007 as a credit crunch crisis. Remember that 20 years earlier the Wall Street crash could be easily overcome through liquidity injection by the United States and Japan without any significant impact on the real economy (Toporowsky, 1993). Not this time, as we will see later on.

It is necessary at this point to explain the links between the governance of firms, the opacity of the new debt instruments and lending policies by financial institutions. The overcoming of stagnation tendencies through the financialization of the economy by means of debt operations, has tied the governance of corporations to the objective of attaining target financial returns not linked to the expansion of production. The real economy must be the instrument for the creation of stockholders’ value. This has nothing to do with the expansion of production and a greater technical efficiency of firms. Asset stripping and disembodying whole companies turned out to be the quickest way to maximize stockholders’ values. In some significant cases this was done indirectly, through the evaluation that financial investors ascribed to firms. For instance, the closing down in 1997 of a brand new Renault plant in Belgium, employing 10000 workers, was the outcome of such an indirect decision by US capital funds. By hook or by crook, the real economy must validate the capital gains aimed at by the debt leveraging activities (Gallino, 2005). As debt issuance became the propelling force for rent seeking objectives, the creation of ad hoc collaterals became equally important. Furthermore, as expectations

about future values depended increasingly upon the adding of further layers of debt, by extending it also to income strata that did not have the required level of income, the packaging of collaterals into complex strata of securities became an art in itself. Such packaging was necessary in order to fill and give substance to securities for which there were no continuous markets. Thus *Mortgage Backed Securities* (MBS) and other *Asset Backed Securities* (often backed by other non hard securities), were then structured in *Collateralised Debt Obligations* (CDO). That is, the non definable securities were packaged together with papers supposedly representing less risky debt positions. But these also were based on suppositions rather than on real data.

Opacity was not a shortcoming of the lending mechanism. It was instead a necessary aspect of it, since it is opacity which gave the possibility that the structured investment vehicles were viewed as real things, based on real assets. The expectations regarding future capital gains connected to those “vehicles” were consensually built up by the collusion between financial companies and the credit rating agencies, themselves in fact a particular set of financial companies charged to validate the activities of the rest. In this case too collusion is a required aspect of the process and not a gap in the regulatory system. As Keynes pointed out long ago, in an era when shares and bonds were straightforwardly identifiable, valuations by capital markets and stock exchanges are like a beauty contest. Constructing the consensus around the “beauty” of structured vehicles as instruments leading to capital gains, became paramount in the present era of non productive, debt driven, rent seeking financial growth. As a consequence, prudential behaviour by financial companies and corporate entities has been virtually eliminated by the fact that, in escaping stagnation, financial gains, especially those linked to the transformation of debt into the main source of those gains, have become the engine and the goal of accumulation which is today centred on capitalized rent. Such reckless behaviour, precisely because it allowed sidestepping stagnation, has been abetted over the years by central banks and by the institutions in charge of regulatory supervision. Mr Greenspan’s testimony to Congress regarding the necessity not to look too deeply into derivatives - since, he observed, one never knows what can happen there - is an absolutely clear statement to that effect.

Europe in the phoney finance vortex

If most of our narrative has, thus far, focussed on the United States, Europe has been fully involved in the crisis in a way which highlights the underlying stagnationist element. It is of interest here to concentrate our attention on the exposure of the German public regional banks, the *Landesbanken*. Banks like the French BNP-Paribas had been hit before the disclosure of the exposure of German regional state owned banks. But, institutions like BNP-Paribas are multinational companies and operate several hedge funds worldwide. By contrast the German regional banks are, so to speak, effective demand banks. Their institutional role is to provide credit for the financing of the real activities of medium and small size firms.

On the 30th of July 2007 the IKB, specializing in lending to this class of firms, showed heavy losses due to “vehicles” connected to the subprime market. IKB was salvaged by means of a consortium of private banks, but few days later the *Landesbanken* crisis came to the fore which, by the time of writing (March 2008), is yet to be extinguished. The *Landesbanken* used to lend on a preferential basis obtaining, by law, lower interest rates on the moneys they borrowed from capital markets. They were thus subsidized because of their function to provide credit facilities for small firms with no oligopolistic and self-financing powers. These firms are the blood vessels feeding the major German oligopolistic corporations and exporters. The financial deregulation imposed by Brussels’ directives, which eliminated the privileged position of the *Landesbanken*, and the prolonged stagnation in domestic demand, pushed the *Landesbanken* to seek gains by dealing in synthetic CDOs. These are even more opaque than the traditional conceived ones. The “synthetics” are derivatives based on betting on the future value of the derivatives that form the original collateral debt obligations. Legally the *Landesbanken* were not entitled to undertake such a game as they were bound by the Basle II capital requirements. They got over that obstacle by setting up off balance sheet conduits.

The widespread use of derivatives of derivatives in Europe, the involvement of the major French private banks and of the whole network of the German *Landesbanken*, explains the swift reaction of the European Central Bank. Its liquidity injections, which began on August 10, far outpaced those of the US Federal Reserve Bank. First the ECB and, somewhat later, also the Chairman of the US Federal Reserve Bank, realized that credit institutions stopped trusting each other. They tended now to reduce interbank lending and increase the risk premium on interest rates charged. The belief that hedge funds, by placing bets in opposite directions, would act as a shield against risk has by now completely collapsed. Bets now appear to be only unidirectional, thereby destroying the predictive powers of the highly computerized models called *quant fund*.

Two new problems started to haunt both private and central banks. One was the vanishing markets and values for the so-called collaterals. It is not that the prices of particular stocks were falling, as it was in 1929 and in 1987 for example. The markets for the CDOs were non-existent in the first place. There were no continuous transactions in mortgage based securities. Their evaluations were imputed ones. Securities tied to mortgages were issued assuming that they would be held till maturity, as indeed they were. In this class of titles it is impossible to have a pair of identical securities. Thus there are no conditions for a continuum of transactions. The market lacks homogeneity. It is for this reason that, legally, the US Securities Exchange Commission allows mortgage based securities to be valued on a virtual basis. With the eruption of the subprime crisis values simply began to vanish. The second problem, connected to the virtual basis of CDOs evaluation pushed by the consensus building rating agencies, consisted in that valueless and hollow securities could not be traced. This means that a contaminated set of CDOs and of synthetics can appear from nowhere, as it is happening right now.

Starting August 2007 a new merry-go-round began which is still going on. The European Central Bank specializes in injecting huge amounts of liquidity, whereas the Federal Reserve, by reversing its earlier stance, injects liquidity while cutting interest rates. The

change of position by the US Federal Reserve is a textbook case of the endogeneity of money. The initial financing by the Fed, made in August, was considered exceptional without entailing a reversal in its longer term stance based on the Taylor's rule. More specifically, its Chairman Ben Bernanke, was in favour of supporting the financial system while allowing for some bankruptcies to stave off moral hazard, increase the price of risk and make, as a consequence, financial investors savvier. Yet, it turned out that moral hazard could not be separated from the overall state of the financial markets, especially when no one knows where the bad securities are and no one can detect them. The search for "quality", that is for safety, by banks and financial companies raised the price of government bonds and securities, thereby automatically reducing the interest rates. The Federal Reserve could not but change its course thereby validating the wishes of financial institutions. The pretence to save the financial system without caving in to moral hazard had been cast aside after a month of hesitations.

Throughout Autumn of 2007 two major tasks fell upon the Federal Reserve: to provide money and cut interest rates. The aim of the latter is to restore confidence in the stock market and the whole decayed system of derivatives. It is now accepted that reductions in interest rates affect first and foremost financial portfolio decisions and not real investment. Also the ECB took upon itself two tasks, one being very different from, yet complementary to, that of the Federal Reserve. The point of unity of the Eurozone is wage deflation and the ECB is the institution entrusted with that task. Hence the political compact that led to the creation of the ECB prevented it from being as flexible as the Federal Reserve.

For both the Federal Reserve and the ECB the events of Autumn and Winter 2007 show the limited real autonomy of central banks. This is further evidenced not only by the jettisoning of the moral hazard argument, but by the systematic acceptance by central banks of hollow CDOs as a guarantee against the money "lent" to financial institutions. Liquidity injections and interest rate cutting, aside from briefly restarting speculative trading, were not doing the trick so that stock markets kept moving downward. And every week or so, a new set of bad CDOs would emerge out of the blue. At the onset of Winter 2007-08, central banks started to inject money in unison while accepting ever lower quality of securities. But even this gimmick did not work, except for few days after each announcement. There are objective reasons for that behaviour. As shown in the case of the British bank Northern Rock, and by the troubles in which the Bank of England found itself for sticking to the moral hazard approach: a run on any single bank threatens that entire system once it is known that the virus can be everywhere. A similar set of considerations applies to the acceptance by central banks of an ever lower class of securities as collaterals following each injection of liquidity.

The joint intervention of the G-10 central banks on March 11 2008 is a case in point. The trap in which central banks find themselves has been well expressed by the president of the New York branch of the Federal Reserve, Tim Geithner. As private banks and financial companies discovered more and more contaminated securities, they proceeded to get rid of them. The attempt to liquidate these securities has set in motion collateral effects in the credits default swap markets, in hedge funds etc. For the G-10 central banks

there was no other way but to give a stamp of validity to the above mentioned bad securities. As new bad instruments are bound to surface the G-10 measures will show up as a mere stop gap measure. The course of events now centres on how deep the US recession will be, notwithstanding the Federal Reserve commitment to support the 145 billion \$ fiscal package decided by Washington in the very first days of 2008.

The claim that it was possible to separate a solid economy from a pathological finance was an illusion at best and, most likely, a deliberate ideological obfuscation. The opening of unlimited credit lines to banks and financial institutions was to no avail, although it has been undertaken with the sole objective of kick-starting once again the financial game of rent seeking via debt creation. With the US in recession and stalling growth both in Europe and in Japan, the crisis, which started as a liquidity one and then turned into an insolvency crisis, has turned into a systemic economic crisis.

The Minsky moment

George Magnus, *senior economic advisor* of UBS, has written in two reports published in 2007 that the United States economy was approaching a “Minsky moment” (Magnus 2007a, 2007b). This expression made the rounds of several blogs and found its way into reputable newspapers like the *Financial Times*, the *Wall Street Journal*, *The Guardian*, *Le Monde Diplomatique*, the *Frankfurter Allgemeine Zeitung* and *La Repubblica*.

Hyman P. Minsky developed a cyclical theory of capitalism characterized by the alternating of speculative bubbles with a tendency towards debt deflation. Marx’s influence was never too disguised, coupled with Schumpeter’s notion of creative destruction extended to financial innovations. Markets do not like Cassandras. And contemporary economic theory, especially the low brow one used routinely by policy advisors and journalists, escapes those who remind the public that equilibrium is, at best, a transitory moment and that, in general systemic centres, of gravity do not exist. How can we then explain Minsky’s come back?

Reconstructing Minsky’s theory is not a trivial matter. Its author was not always rigorous and analytically consistent. Yet the vision he put forward is simple and powerful (cfr. Bellofiore-Ferri 2001). Investment in fixed capital goods is the hub of income and employment determination. The purchase of new capital goods has financial determinants and the stock exchange is subject to speculative waves. The crucial problem with capitalism is that stability is destabilizing. To show the contradiction inherent in the very stability of the system, Minsky argued that the cycle begins with a smooth expansion and a robust financial basis. Initially mindful of past crises, entrepreneurs as well as financiers behave in a risk averse manner. In such an environment, interest rates are low and stable, the supply of money is virtually limitless. The risk averse behaviour of firms and banks alike implies that borrowers are, on the whole, capable of repaying with their regular flow of earnings both the interest and the part of the principal stipulated in the lending agreements. If everything goes as planned, there will be residual profits which

validate the previous financial commitment thereby stimulating to enter into new ones. This is what Minsky called a “hedge” financial position.

Minsky posited that for a while things do go well so that profits exceed expectations. There develops, therefore, among business people a lesser risk aversion and a greater disposition to take on additional debt. The process will not be blocked by a possible reluctance by the central bank to increase the supply of money, since financial intermediaries will invent new payment instruments which will be accepted as liquid. The price of money remains unchanged while indebtedness grows. In the new euphoric environment “speculative” positions are being formed: cash flow earnings allow for the servicing of the interest on debt but no longer suffice to cover, in every period, the part of the principal which is due. Thus the refinancing of debt positions becomes necessary for some periods at least. During the initial phase of smooth expansion with hedge positions, a crisis could erupt only because of an economic risk, due to the non validation of profit expectations because of occurrences on the product and/or labour markets. In the boom phase those who take a “speculative” debt position must face up not only to the economic risk, but also to a financial risk – such as an increase in the short term interest rate by the central bank - which may swing expected gains into actual losses. The same situation will arise if the assets acquired by means of debt begin to lose value.

Speculative positions allow for a higher long term investment but make the economy more fragile. As optimism and euphoria multiply, the boom degenerates into a bubble where operators prone to take ultra-speculative positions tend to prevail. This is the “Ponzi” finance case. Now those who enter into debt commitments are saddled with interest payments exceeding cash flow earning for a substantial number of periods. Either refinancing is increased or activities must be liquidated. An ultra-speculative position is held if one believes in the eventual manifestation of exceptional profits, or in capital gains due to asset price inflation. Small unexpected variations in short term interest rates and/or a deflation in asset prices give way to the crisis. This is so because during the times of euphoria economic actors – banks, firms, speculators – have been reducing their money balances and liquidity. With the crisis the preference for liquidity comes back with a vengeance.

“Things fall apart; the centre cannot hold” is a Yeats verse that Minsky loved to cite. The fear of a new Great Depression like in the 1930s is resurfacing. Can ‘it’ happen again? Minsky did address this question by answering in the negative. Pushed to the wall the authorities in charge of economic policies know how to avoid a repetition of that crisis, firstly by replenishing markets with liquidity and, secondly, by reducing interest rates. However, according to Minsky, these measures would not do if insolvency is the root problem. The central bank’s role as a lender of last resort is crucial but not sufficient since monetary policy has a limited impact. State intervention must be envisaged instead with budget deficits aimed at sustaining money profits. Here Minsky argued in terms of Kalecki’s macroeconomic accounting where gross profits are positively related to the government deficit. An active anti-cyclical fiscal policy is thus necessary to avoid sinking into a depression. Economic liberalism, with its myth of a small government and a light State, is neither a leftwing or rightwing policy. It is just a stupid policy and, as opined by

Minsky, it will never be implemented again in practice in a durable manner. Meanwhile the standard Keynesian solution -based on cheap money plus Big Government's deficits - will create new problems such as stagflation and an even greater appetite by banks and financial intermediaries for financial innovations. It will lead to the reappearance of the credit cycle and to new spirals of euphoria and panic at ever closer intervals.

With some provisos to be specified in the next section, the financial instability hypothesis is well adapted to the events that unfolded throughout 2007 and in particular since the Summer of that year. It would not be the first time. Minsky laid out the conceptual basis of his hypothesis between the 1960s and the 1970s when the Keynesian era was in full blossom. Confirmations of the Minsky hypothesis were not late in coming after the end of the long boom: the Mexican crisis of 1982, the Wall Street crash of 1987, the two crises linked to real estate prices such as the Savings & Loans default and the Japanese crisis of the early 1990s. After Minsky's death in 1996, further confirmations of financial instability came with the East Asian crisis in 1997, the collapse of Long Term Capital Management in 1998, and with the pricking of the dotcom bubble in 2000-01.

Minsky's Financial Instability Hypothesis in the subprime crisis: a brief assessment

The development of a Minskyian interpretation of contemporary capitalism and financial crises would require tackling four problems. First of all, the financial instability thesis, despite its strong intuitive content, is not without analytical difficulties. Minsky's view is that the leverage ratio – i.e. the ratio between debt and owned capital – grows with the expansion of the economy. There is no compelling reason for such a tendency to materialize. During prosperity total profits grow as well. While firms taken individually do borrow, the debt ratio for the whole system of firms need not vary. Indeed, as we know from Kalecki, with the borrowed money the single firm spends in order to undertake investment in plant and equipment. The payment for the investment orders becomes profit for the firms supplying the capital equipment. In 2000-01 there was in fact an increase in the overall leverage ratio of firms. It has been followed by a decline in the ratio during the stagnant two years that ended with the Iraq war. The financial position of US non financial corporations came out to be positive and in excess of the amount of real investment undertaken by the non financial private sector. This sector ended up providing capital to the financial markets.

Secondly, Minsky's dynamics focussed on the demand for capital goods and its financing. The boom of the 'new economy' cannot be fully explained by the level of real investment, which remained flat in the post 2003 recovery.

Thirdly, in the new configuration of capitalism since the mid-1990s, monetary policy seemed capable to activate the autonomous expansion of consumption, thereby bypassing for a while the dependency of effective demand upon aggregate investment. The relaxation of the effective demand constraint was made possible by the central bank's support to debt bubbles and the related wealth effects.

Fourthly, the recent speculative bubbles have not been accompanied by a wage and price inflation. The increase in product prices has been actually mostly due to the rise in the raw materials' costs, in commodities and in oil, not to wages (the Phillips curve turned to be flat).

A Minsky dynamics has, indeed, occurred but elsewhere and with a different set of modalities compared to those envisaged by the author. We must direct our attention to households and to financial intermediaries. This means looking at the increasingly indebted consumers, and at investors in the stock and real estate markets affected by a manic-depressive syndrome. It also means looking at the labour market and at the labour process. The 'new' capitalism arises from the long wave of assault on wages and welfare provisions initiated by Volcker and President Reagan. With this background, the primacy of finance translates itself into a permanent restructuring of the production and valorization processes (exploitation of workers under increasingly flexible occupations and wages, with a lengthening and an intensification of labour time). The restructuring processes have given rise to a centralization of capital without an expansion of technical concentration (outsourcing and subcontracting by hitherto integrated oligopolistic firms).

These processes have entailed a global relocation of the manufacturing industries which feed upon the doubling of the industrial reserve army and the capitalist growth in China and, more recently, in India. The above has produced a further, quite dramatic, fragmentation and disarticulation of labour. It is also because of these two factors that the explosion of liquidity throughout the 1990s and exponentially after 2001, did not generate a rise in wages and in product prices, at least in the old industrial countries. It rather fed directly into financial and real estate activities, oil and energy resources and in whatever may have seemed to ensure speculative gains.

The new capitalism, born in the USA

During the 1980s the liberalization of capital movements, monetary restrictions, the dismantling of the welfare state, the aggressive competition by the global players, have set in motion a powerful stagnationist tendency. These policies operated against the expansion of real investment and of real wages, upon which depends the expansion of effective demand. The share of wages began to fall and also the investment share over national income declined. The only countertendency came from the military induced government deficit of the Reagan years augmented by tax reductions for the wealthy. Something that Bush Jr would repeat at the beginning of third millennium. Under Reagan the conjunction of restrictive monetary policies and expansive fiscal policies, in marked contrast with Europe, caused a sharp rise in the price of financial activities. The differential in the level of interest rates in favour of the United States led to capital inflows and to a revaluation of the US dollar. As a consequence US external deficit ballooned, but it was not perceived as a constraint in a country whose currency is also the main international reserve currency.

The dynamics of the 1980s, marked by several shocks, did not lead to the rapid emergence of a new model. This happened only in the mid 1990s after a decade of coordinated policies to devalue the US\$ undertaken by the major central banks and governments with the Plaza accords in New York on the 22nd of September 1985. Concomitantly with the devaluation of the US dollar, lasting until 1995, wage deflation became the permanent feature of both the United States – where real wages have been falling since 1974 – and of the countries of European Union which would form the Eurozone. The qualitative change that, at the beginning of this essay, we called the trinity constituted by the traumatized worker, the indebted consumer and by the manic-depressive saver, materialized in the course of the post 1995 evolution of the international economy. It is in this phase that labour is finally “really subsumed” to finance and debt in a manner which directly impacts on the immediate exploitation within the capitalist labour processes.

To understand how labour has been subsumed by finance we may start from the rise of the *new economy*, seen more as a virtuous interaction (in the United States) between a strong dollar and a monetary policy aimed at sustaining the forms of debt financing. In July 1995, the dollar was pushed up sharply by a joint operation of the Federal Reserve, the Bank of Japan, and the Bundesbank, in order to avoid a collapse of the Japanese economy. Financial innovations, coupled with a shift in investors’ savings from government bonds to stocks, give rise to a speculative bubble based on totally unrealistic expectations regarding the profitability of the new virtual economy. The centralization of financial capital in Wall Street based activities had been made easier by the prolonged Japanese recession and by the European stagnation. A number of financial crises in the world, such as the Asian crisis of 1997/8, the Brazilian and Russian crises of 1998, entailed a massive flight of capital towards the United States. Thanks also to the worldwide activities of pension funds, more money flowed to the United States allowing the country to sustain a widening current account deficit. Markets’ irrational exuberance reached a paroxysmal state, until the sudden rise in interest rates decided by the Federal Reserve in 1999 brought about the deflation of the dotcom bubble.

The new stock market economy must be understood in a global macroeconomic framework and in its role as an effective device of a paradoxical *financial Keynesianism* – a capitalist setting where effective demand is provided thanks to asset-bubbles which are politically manipulated. Outside the Anglo-Saxon countries (especially outside the United States, the United Kingdom, and Australia and New Zealand; Canada with its hefty current account surpluses being in a different position), there exists an excess of aggregate income over aggregate expenditure. This is the outcome of a long standing neomercantilist institutionalized policy which Washington itself helped to shape for about 4 decades after 1945 in Asia, with Japan, South Korea and Taiwan, and for three decades in Continental Europe. To that institutional dimension we should add the explicit neomercantilist policies pursued in Europe by means of deflations and competitive devaluations. The need to find market outlets is thus permanent and acute, especially with the onset of stagnation in 1975. In this context the United States has become the catalyst of world effective demand.

But how can the US sustain such a role? We know from simple macroeconomic accounting that the level of aggregate demand in any single country is positively related to investment, consumption, net government spending and net exports. This last aspect is not operational in the US because of the size of the current account deficit. During the 1995-2000 period net government spending was weak and mostly negative (since the State budget was in surplus under Clinton). Thus the components that supported US aggregate national income came from investment and consumption. Yet, as already observed, investment was not strong after the dot.com crisis. Non financial corporations became in fact lenders to the capital markets. It follows therefore that the main stimulus to aggregate income in the US was from consumption, later buttressed by the military Keynesianism of Bush Jr after 2001. On balance it has been the private sector debt to provide the necessary stimuli and, in this context, it was household debt which played the dominant role. Given the stagnation and fall in real wages, effective demand for housing and consumption goods could be created only via increased debt made possible by expectations regarding asset (real estate) price inflation. The mechanism was centred on the inflation of financial assets, of stocks, which quite quickly gave rise to a rising discrepancy in the price earnings ratios. Earnings from assets did not rise as much as asset prices. This state of affairs should have brought the system to a halt. But, because the entire institutional, political and monetary systems were behind the casino like activities, the show went on. Indeed bets were placed not on earnings but on the appreciation of assets, thereby leading to mythical beliefs in the long term nature of wealth effects. Bank and financial intermediaries transformed paper wealth in a bottomless expenditure via household's debt. The wealth effect impacted on the economy by augmenting enormously the autonomous component of consumption and housing demand, delinking it from current disposable incomes.

The explosion of the dotcom bubble in 2000-01 was a major sign that the process was not sustainable. Shortly afterwards the US dollar started a new downward trend. The crisis lasted till the middle of 2003 and was stopped by means of higher military spending and of ever greater injections of liquidity, and by tax reductions for the wealthy. In three years the government deficit rose to more than 7% of GDP and the current account deficit hovered around that figure as well. It is only after the slow down in the economy's growth, and in the wake of a renewed decline of the dollar, that the external deficit settles back to 5% by 2007. In the case of the United States, the devaluation of the currency generates a disposition towards debt since domestic and foreign liabilities are denominated in dollars but foreign assets, and US multinational and financial companies operate deeply in Europe, are denominated in appreciating currencies.

Given that firms have become net lenders by spending less than corporate savings, how can growth be kick-started again? It is done simply by injecting more of the same drug which stimulates households' consumption. The real estate market, favoured by the extremely low interest rates practiced by the Federal Reserve in order to sustain the US economy after the dot.com crisis and the Twin Towers, came to the rescue of the economy. With rising prices and the renegotiation of flexible interest rates mortgages, houses become a cash dispensing machine. As in the 1995-2000 period, a situation of this kind could not have been achievable without the assuaging policies of the central bank.

The Federal Reserve has helped demand, firstly by supporting real estate inflation and, secondly, by approving and backing the new credit instruments financed by commercial banks. The sustainability of this paper pyramid rested upon the willingness of the foreign holders of dollars, among them first and foremost China, to refinance the external deficit of the country.

In 2004, when interest rates began to rise again, the real estate market is immediately affected and the transmission mechanism of the new monetary policy became perverse. The financial companies knew very well that they were sucking poor households into the subprime market. But bringing insolvent families into the fray was a necessity dictated by the expanding circuits of capital without which the notion of future capital gains becomes meaningless. The act of subsuming labour to debt allowed an easy access to the ownership of a capital asset. The strategy was that of expanding the spiral of debt capital to an ever growing number of poor people by offering negative equity loans (involving loans greater than the value of collaterals), offering schemes where the interest was to be paid in perpetuity without having to repay the principal, and so on. But when earned incomes became insufficient to meet payments things started to go badly also for creditors who could repossess the house but in a market where prices were falling. The values of the collaterals packaged away to hedge funds turned out to be hollow, and the 'subprime' crisis materializes into a fully fledged economic crisis.

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