

Minsky's Money Manager Capitalism: Crisis and Reform

L. Randall Wray, Professor of Economics
University of Missouri-Kansas City

wrayr@umkc.edu

www.levy.org

www.cfeps.org

Finance Capitalism

- Characteristics of Finance Capitalism
 - Complex, long-lived capital assets
 - Requires external finance, prior commitments of earnings
- First version: small govt, laissez faire; failed
- New Deal → big govt, paternalistic state
 - High W, High C, Unions, Welfare
 - Growth leveraged Treasuries from WWII
 - Big Govt: multiplier, cash flow, portfolio effects
- Finance Capital returned in the form of Money manager capitalism: Big Govt, Predator State

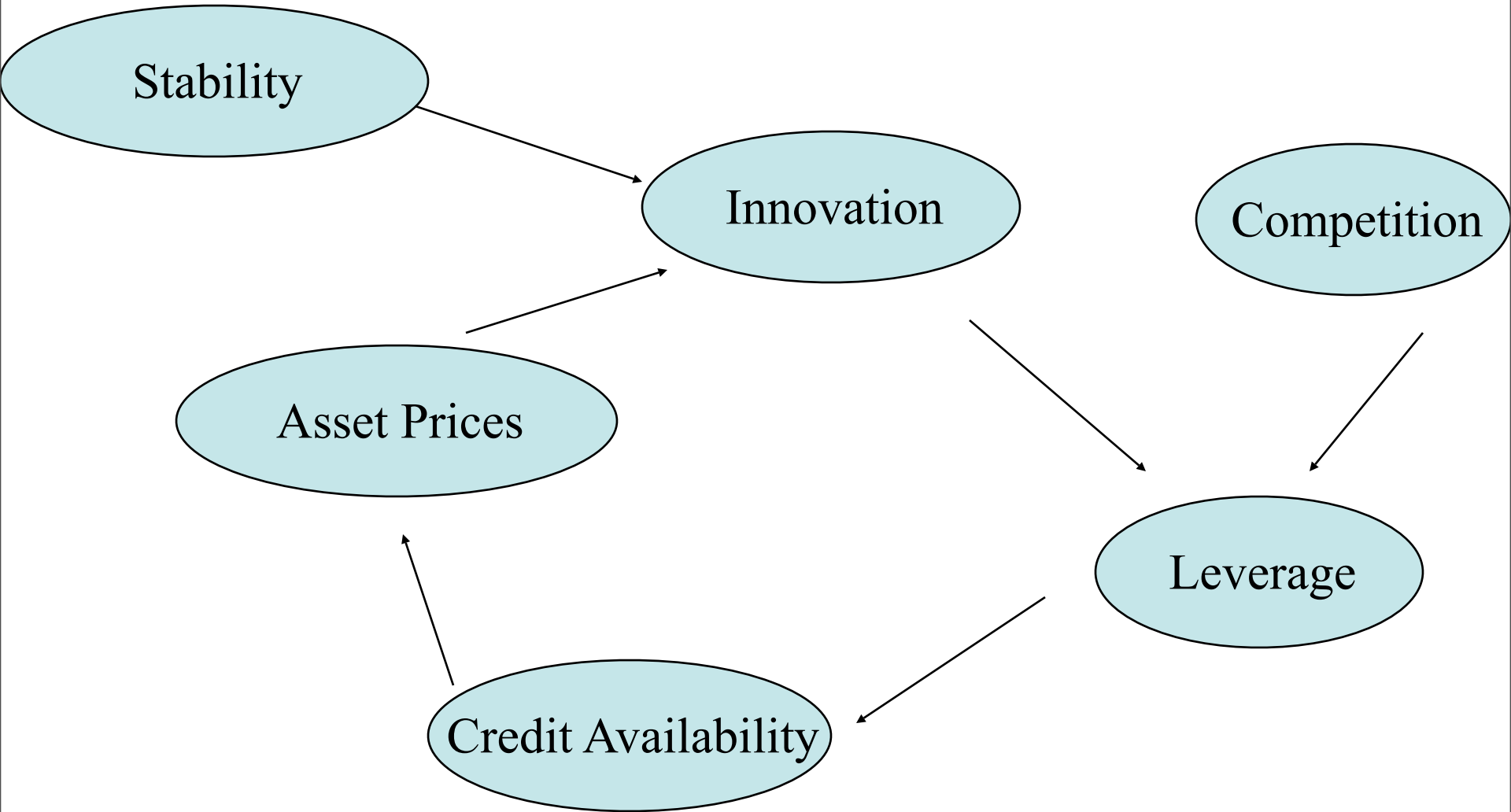
Managed Money and the Systemic Nature of the Crisis

- *Irrational exuberance; Minsky Moment?*
No—seeds of crisis sown long ago.
 - By Fed's increasingly aggressive use of rate changes to fine-tune economy
 - By financial institution innovations to make credit more elastic
 - By deregulation and gradual removal of New Deal constraints
 - By growth of managed money with appetite for risk and high leverage

Stability is Destabilizing

- If risky innovations had led to losses, they wouldn't have been retained
- But Big Bank and Big Gov't constrained instability; allowed fragility to increase
- And allowed managed money to grow
- Shifted weight of financial system away from regulated/protected banks to pension funds, mutual funds, ABS issuers, REITs

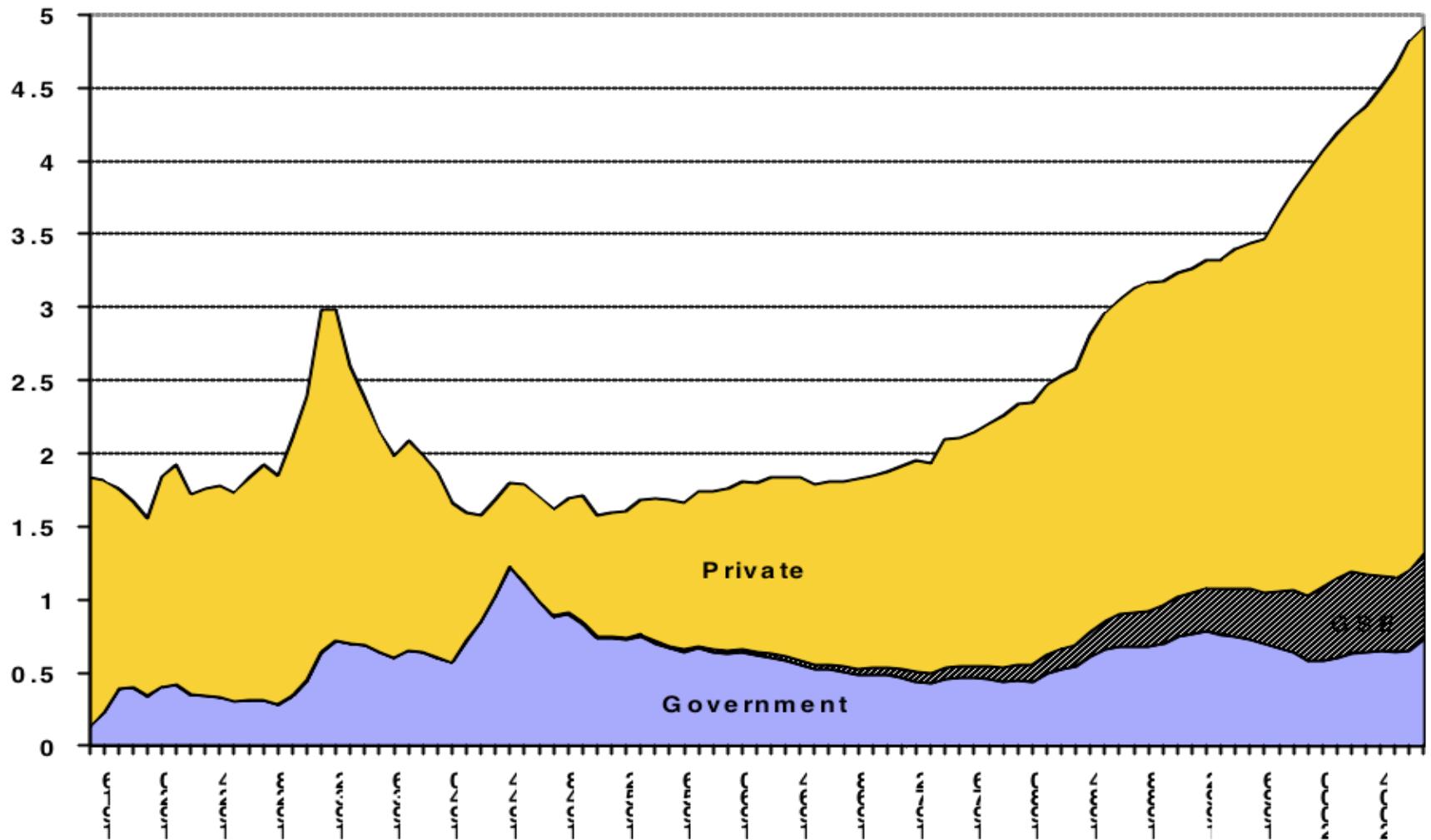
Virtuous Cycle



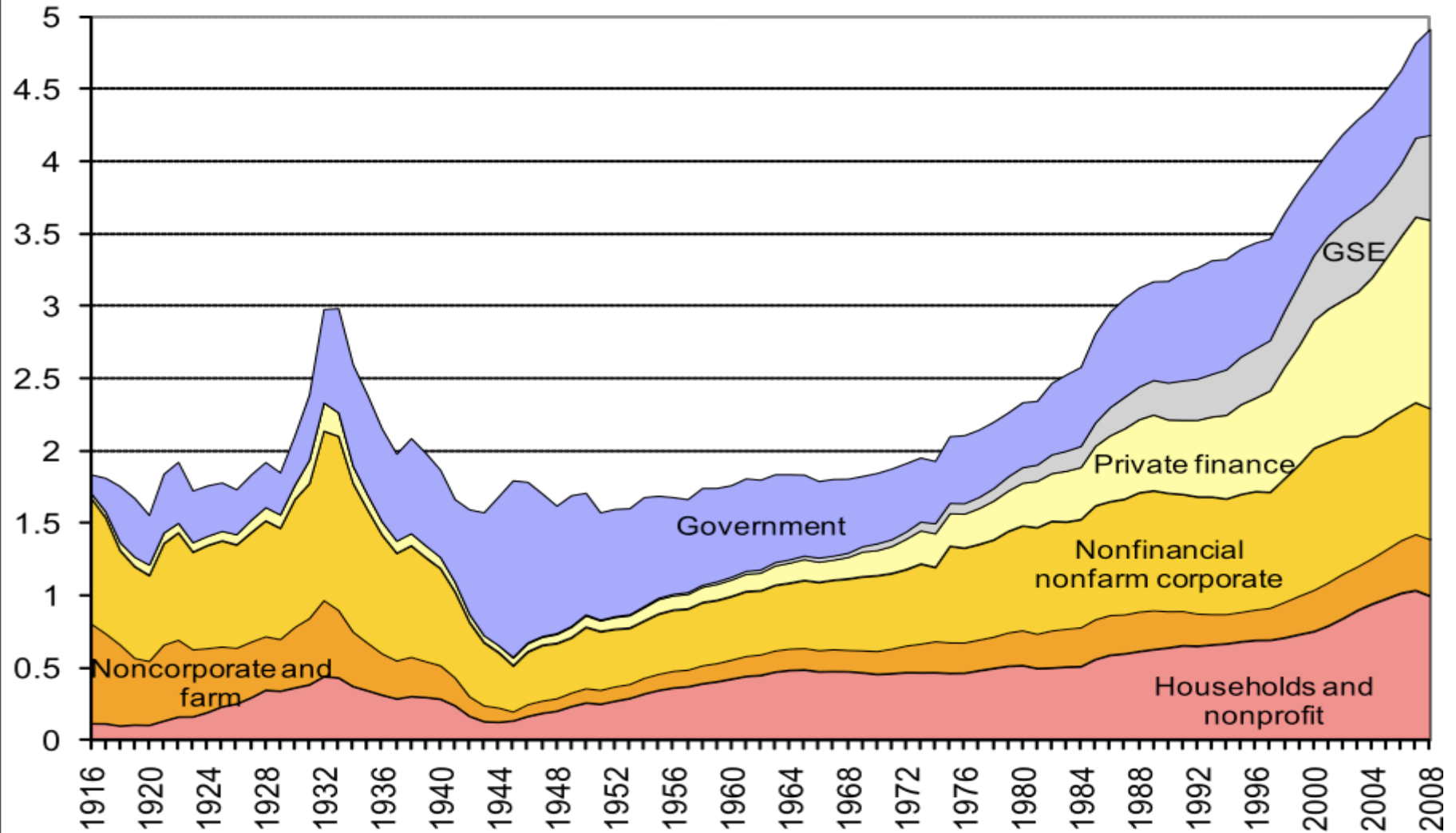
Boom and Bust

- 1980s Thrift & Bank Crises
 - Thrifts and Commercial real estate
 - Banks and LDC debt
- 1980s Leverage Buy-outs
 - Michael Milken and Junk Bonds
- 1990s New Economy and Nasdaq
 - “Irrational Exuberance”
- 2000s Residential Real Estate
- 2000s Credit Default Swaps
 - Subprimes; foreclosures
- 2000s Commodity Markets
 - Quadrupled oil prices; food riots; starvation

Financial Liabilities Relative to GDP



Liabilities relative to GDP by Sector



Leverage and the boom

- Income was leveraged by firms & HH
- Financial institutions leveraged equity and safe assets, including treasuries
- Financial institutions moved assets and liabilities off-balance sheet but kept the risk, further increasing leverage
- FIRE sector leveraged rest of economy as it grew faster than “real economy” (40% of corp profits; 8.2% of PCE)
- Leverage implies explosive growth in boom

Securitization and Leverage

- Minsky: securitization is part and parcel of globalization of finance
 - **And of shift from banks to managed money**—financialization, market fundamentalism, transactions-oriented capitalism, Neocon ownership society, or money manager capitalism
- Securitization+leverage: Increased through-put; Minsky: “make up for loss on the carry by increasing volume”
- Increased importance of mkt valuation of assets; positive feedback
- Increased portion of system outside Fed oversight and explicit protection,
 - increased complex and unknown linkages, off-balance sheet commitments
 - increased likelihood that liquidity problems→solvency crisis→liquidity crisis

Securitization and Efficiency: conventional views

- Lower spreads as evidence of rising efficiency; homeownership spreading; democratization of access to credit: Low doc→No doc→NINJA
- Risks efficiently priced; reduced by diversification; shifted to those best able to bear
- Reality:
 - Risks never assessed; returns didn't cover
 - Risks not reduced; not shifted.
 - Home finance was massive Ponzi scheme: req'd rising asset values and refinance at favorable terms
 - Not limited to subprimes or even RMBS

Commodities Boom

- Boom begins 2004; accelerates as housing slows: MM search for returns
- 2004-06: Speculation in Physicals
- 2006-08: Index speculation in Futures Markets
- Players: hedge funds, pension funds, sovereign wealth funds, Euro banks
- Method: buy-and-hold (long) portfolio allocation strategy

Index Speculators

- Prudent investor rule: commodities banned because purely speculative
- Collapse of High Tech → search for alternative asset class
- Discover: commodos uncorrelated with fixed income and equities; and inflation hedge
- CFTC and Goldman push commodos as new asset class
- Hold futures rather than physicals; allocate (buy and hold)

Broad-based boom

- 20th Century: only 13 instances of P of commod rising 500% or more
- Current boom: 8 commods already
 - Heating oil 1313%
 - Nickel 1273%
 - Crude oil 1205%
 - Lead 870%
 - Copper 606%
 - Zinc 616%
 - Tin 510%
 - Wheat 500%

Commodity Purchases By Index Speculators The Last 5 Years

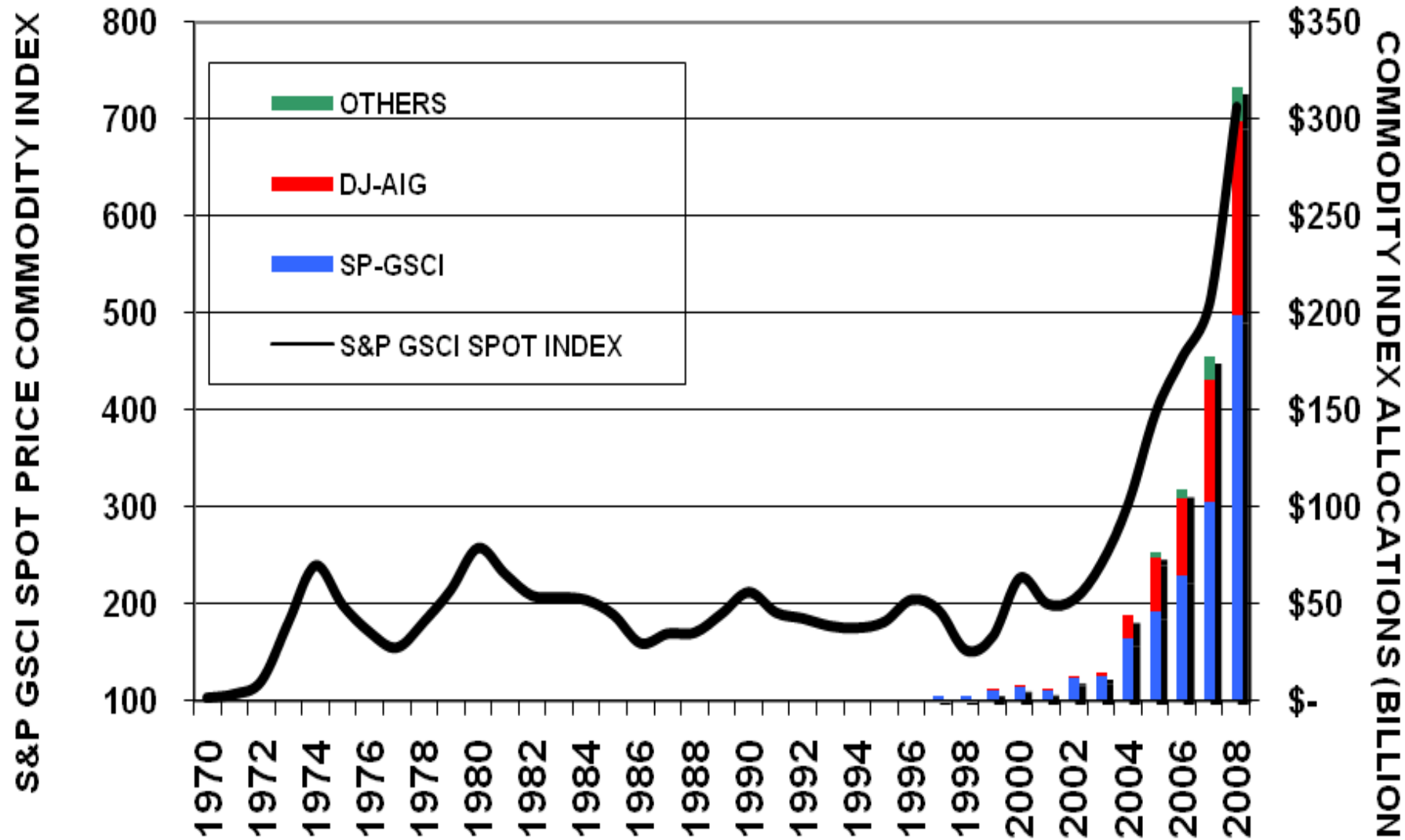
Sector	Commodity	Units	Previous Futures Market Stockpile January 1, 2003	Net Purchases Last 5 1/2 Years	Current Futures Market Stockpile March 12, 2008
Agricultural	Cocoa	Metric Tons	18,828	303,352	322,180
	Coffee	Pounds	195,716,944	2,238,858,056	2,434,575,000
	Corn	Bushels	242,561,708	2,138,383,292	2,380,945,000
	Cotton	Pounds	544,934,999	5,548,915,001	6,093,850,000
	Soybean Oil	Pounds	163,135,678	4,312,624,322	4,475,760,000
	Soybeans	Bushels	81,028,272	890,616,728	971,645,000
	Sugar	Pounds	2,291,358,746	46,094,097,254	48,385,456,000
	Wheat	Bushels	166,738,225	967,351,775	1,134,090,000
	Wheat KC	Bushels	54,746,014	102,618,986	157,365,000
Livestock	Feed Cattle	Pounds	104,446,612	365,453,388	469,900,000
	Lean Hogs	Pounds	517,414,747	3,827,425,253	4,344,840,000
	Live Cattle	Pounds	669,766,732	5,099,033,268	5,768,800,000
Energy	Brent Crude Oil	Barrels	47,075,357	144,524,265	191,599,621
	WTI Crude Oil	Barrels	99,880,741	538,499,579	638,380,320
	Gasoil	Metric Tons	1,682,662	6,027,680	7,710,342
	Heating Oil	Gallons	1,067,859,608	2,568,925,661	3,636,785,269
	Gasoline	Gallons	1,102,184,401	2,488,458,616	3,590,643,018
	Natural Gas	Million BTUs	330,652,415	1,932,356,225	2,263,008,640
Base Metals	Aluminum	Metric Tons	344,246	3,232,406	3,576,652
	Lead	Metric Tons	82,019	158,726	240,745
	Nickel	Metric Tons	20,147	101,988	122,135
	Zinc	Metric Tons	133,381	1,182,091	1,315,472
	Copper	Metric Tons	220,096	1,144,538	1,364,634
Precious Metals	Gold	Troy Ounces	979,863	8,742,401	9,722,264
	Silver	Troy Ounces	11,126,862	152,866,187	163,993,049

Sources: Goldman Sachs, Standard & Poors, Dow Jones,
CFTC Commitments of Traders CIT Supplement, calculations

Flows of index speculation funds and spot prices

- Warning: correlation is not causation
- And causation probably goes both ways:
flows → drive up prices → more flows
- But a perfect correlation merits investigation!

S&P GSCI Spot Price Index vs. Index Speculator Assets



Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report

CDS “insurance”

- No worries, we’ve got CDS “insurance”
- Between \$60T to \$70T. Yes, that is **Trillions**
- Held and sold by Banks and Hedge Funds as insurance
- David Li’s Gaussian Copula function: use CDS prices plus efficient mkts hypoth→price risk; buying CDS is equivalent to buying bond of same risk
- So used to make bets on death of assets, firms, and countries
- Key differences from normal insurance: no direct interest, and no loss reserves

CDS Explained

- I *sell* 1 million life insurance policies to you on a 90 year old nursing home patient for \$1M each @ \$50 → I book revenue \$50M
- Patient worsens; premium rises to \$100
- You *sell* 1 million policies @ \$100, book profit = \$50M
- You are fully hedged: if patient dies, I pay you \$1M and you pay out \$1M
- See any counterparty risk????



LEHMAN BROTHERS

WALL ST

BEAR STEARNS

I'M AFRAID
OUR EXPERIMENTS
HAVE CREATED
A BLACK HOLE

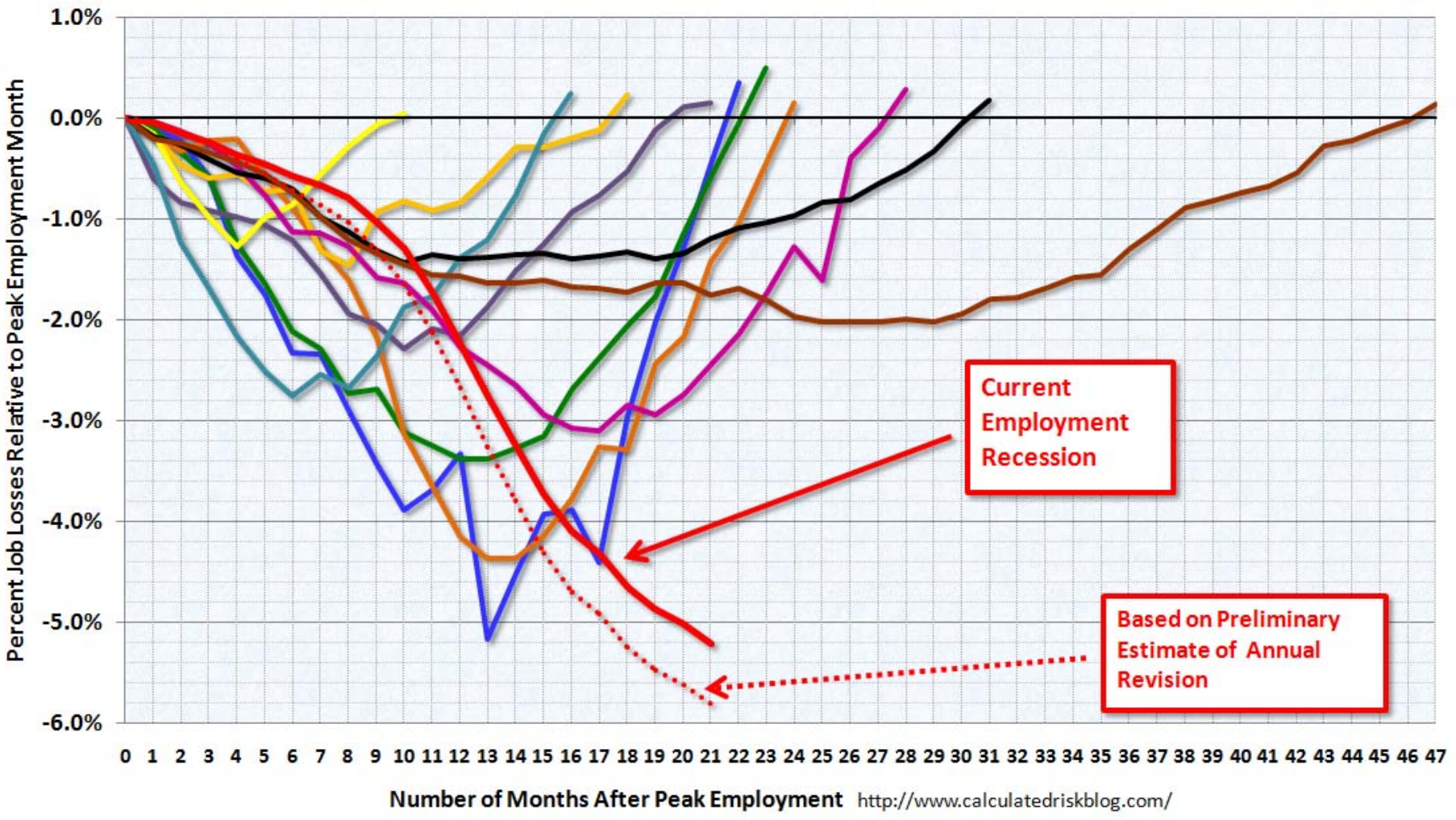
CHAPPATTE

De-leverage: the ugly side of leverage

- De-lever = reverse all those ratios: with leverage ratio of 20, to reduce portfolio wt in an asset class, must sell 20
- Institutions follow similar strategies on way up, so must sell into declining mkts
- Since \$19 of every \$20 is borrowed, must continue to finance positions as values fall
- Off-balance sheet risk came back onto BS
- insolvency → bet the bank

Percent Job Losses in Post WWII Recessions

- 1948
- 1953
- 1958
- 1960
- 1969
- 1974
- 1980
- 1981
- 1990
- 2001
- 2007
- 2007 (adjusted)



<http://www.calculatedriskblog.com/>

Obama's Recovery Plan

- ARRA: \$787 billion for stimulus.
 - \$150 billion to state and local governments and unemployment benefits,
 - \$250 billion to households (tax cuts and some social spending),
 - \$200 billion to infrastructure

Address inequality: strengthen unions, raise min wage, reduce taxes for middle-class
- All of these good ideas endangered by Timmy and Larry Side Show \$23.7 trillion:
 - TARPS, PPIPS, TALFs, M-LECs, Fed purchases of toxic waste, and other bailouts: life insurance, auto manufacturers, credit cards issuers, LBOs
 - Beyond bailouts: recruiting “mainstreet” to buy junk assets w/leverage
 - Reproducing conditions of 2006: high leverage, stated values, opaque deals, wrong incentive structure

Paulson/Geithner Plans: **Trying to restore Money Manager Capitalism**

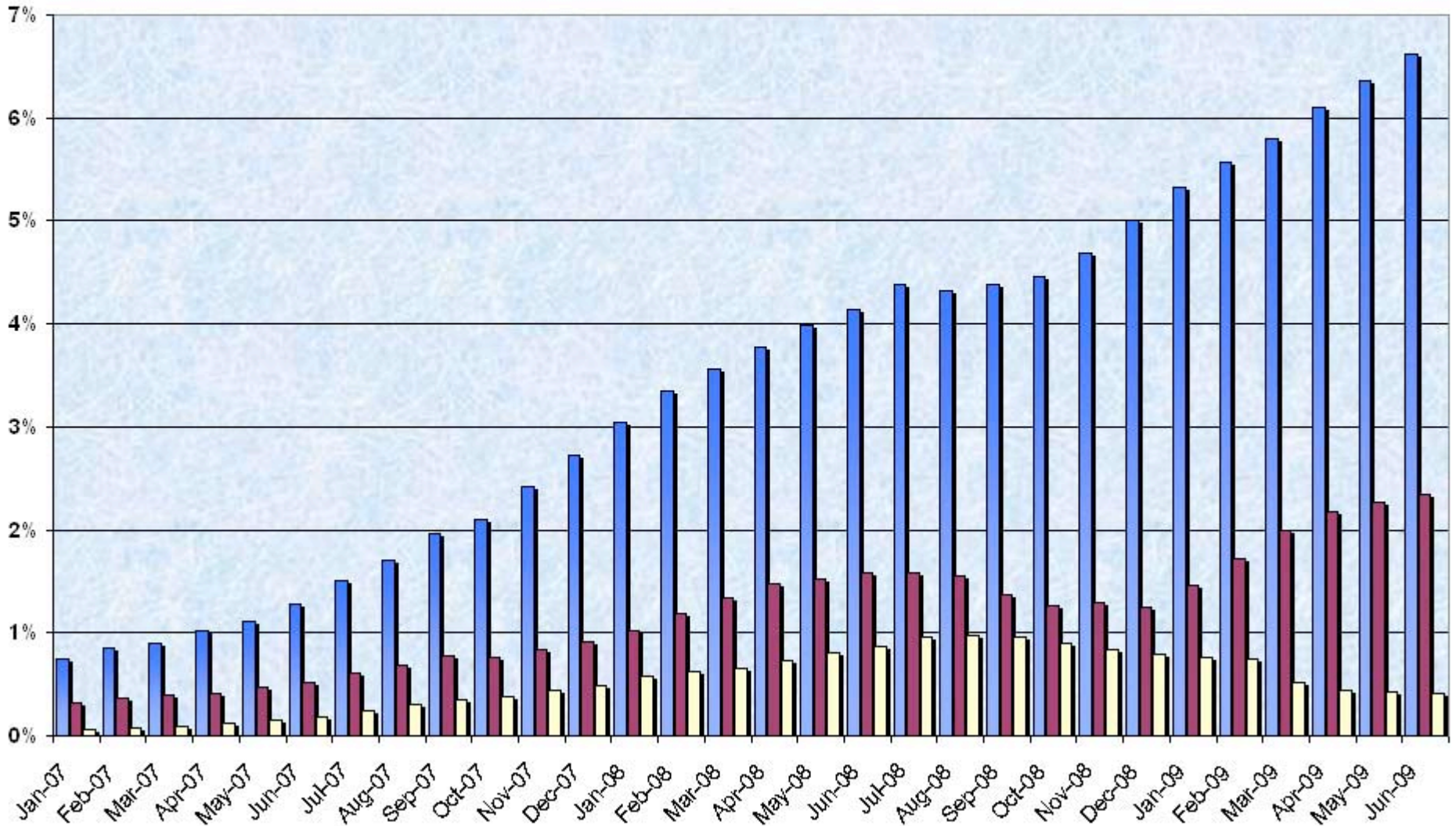


GLOBAL ASSETS UNDER MNGMT: FALLS TO \$92.4T

REGION	2008	2007	% CHANGE
EUROPE	32.7	34.7	-5.8
USA&CAN	29.3	37.4	-21.7
ADA			
JAPAN	13.5	14.7	-8.2
ASIA EX JAPAN	11.5	12.2	-5.7
MID EAST&AF RICA	3	3.2	-6.3

Delinquencies and foreclosures

■ 90+ Day Delinquency Rate ■ Foreclosure Rate □ REO Rate



Congressional Oversight Panel: All successful crisis resolutions required:

- **Transparency.** Swift action to ensure the integrity of bank accounting, to ascertain the value of bank assets and hence assess bank solvency
- **Assertiveness.** Willingness to (1) take early aggressive action to improve capital ratios of banks that can be rescued, and (2) shut down banks that are irreparably insolvent.
- **Accountability.** Willingness to hold management accountable by replacing – and, in cases of criminal conduct, prosecuting – failed managers.
- **Clarity.** Transparency in the government response with reporting of all forms of assistance being provided and clearly explained criteria for the use of public sector funds.

4 strikes and you're out?

Short run crisis package

- Liquidity: Urgent; Lend w/o limit or collateral to all; expand FDIC
- Insolvency: No urgency; Now need receivership, replace and constrain mngmt; Adopt too big to save doctrine for systemically dangerous
- Get on right side of 30-1 leverage
- Stimulus: need tax relief *and* govt spending:
 - Unemp comp, infrastructure, \$400B block grants
 - Payroll tax holiday: \$4025 saving for average worker and same for her firm
- Jail the crooks: vastly increase budgets, hire criminologists, pursue up the entire real estate food chain: originators, appraisers, accountants, risk raters, and Wall St money mngrs



Downsizing

- **Bring all bank assets and liabilities onto balance sheets; subject to reserve and capital requirements and—more importantly—to normal oversight by appropriate regulatory agencies.**
 - **Any assets and liabilities that are off balance sheet will be declared null and void, unenforceable by US courts.**
- **All CDSs must be bought and sold on regulated exchanges; otherwise they will be declared unenforceable by US courts.**
- **Unless specifically approved by Congress, securitization of financial products such as life insurance policies will be prohibited and thus unenforceable by US courts.**
- **Congress will consider whether the proposed financial products serve a legitimate public interest that cannot be better served through some other mechanism.**

Downsizing con't

- Examine largest 25 insured banks to net all CDSs. CDS contracts with foreign banks will be unwound.
- Examine derivative positions to determine whether unwinding would be in the public interest. Goal: downsize “megabanks” to reduce systemic risk.
- Determine which banks are insolvent based on current market values—after netting positions. Resolve the insolvent while i) minimizing cost to FDIC and ii) minimizing impacts on the rest of the banking system.
- Must cover some uninsured losses to other financial institutions as well as to equity holders (such as pension funds)
- Direct Treasury and Fed to reduce concentration of financial sector by avoiding resolution methods that favor large institutions.
- There will be a bias toward rescue of smaller institutions, and use of the resolution process to break-up the larger institutions.

A Minskian New Deal, Part I

- Payroll tax reform: regressive, inflationary, discourages employment. Abolish Trust Fund; paygo and tax all income to share *real* burden
- State and local govt: reverse devolution; eliminate regressive taxes, Fedgovt replace lost revenue \$for\$
- Inequality: unions, min wage, good jobs
- Reform retirement: more generous public system; less subsidy to money mngrs
- Health care: nationalized, de-financialized

A Minskian New Deal, Part II

- Infrastructure and social spending: govt ratchet, permanent to enhance stability
- Financial reform: Listen to mkt: we don't need NINJAs or rocket scientists or Chinese finance of US homeownership.
- Govt of, by, and for Goldman is no way to run a country; Euthanize Wall St.: drive stake through heart of M-Mngr capitalism

Return of Fiscal Policy

- Affordability: gov't can afford to buy anything for sale in domestic currency
- Can always achieve full emp
- Can enhance price stability
- Can enhance economic stability (income, output)
- Can enhance financial stability
- How: Minsky's ELR program: Job guarantee: human rights, equity, efficiency, and stability all require jobs: 12-20 Million permanent jobs

Conclusion: What we learned from Minsky

- Great Depression = failure of small govt, laissez faire economy
- New Deal promoted highly successful Big Govt/Big Bank model
- Stability bred instability, promoted by deregulation and successful innovations
- Current crisis decisively repudiates Big Govt/NeoCon model that favors self-supervised mkts and socialized risk