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Introduction

"A new era of reform cannot simply be a work of piecemeal changes. Rather a thorough, integrated approach to our economic problems must be developed; policy must range over the entire economic landscape and fit the pieces together in a consistent, workable way: Piecemeal approaches and patchwork changes will only make a bad situation worse" (Minsky, 1986).

Many have presented explanations for the meltdown of financial markets in 2008 including but not limited to: irrational exuberance, a disintegration in ethical behaviour that caused lax regulation, over sight and greed, loop holes in accounting standards, inadequate incentives that caused control fraud, international imbalances in security markets, easy money policy, low interest rates, growing inequality that encouraged households to obtain loans for increased spending etc. Unfortunately none of above fully satisfies the causes of recent financial crisis (Dimitri, 2012).

Nobody should consider the global financial crisis as simply a moment that can be tracked to latest developments. It should be viewed a Minsky had been proposing for 50 years. The crisis is slow transformation of global financial system into what Minsky called a "Money Manager Capitalism". The system finally collapsed in 2007. Therefore it should be a "Minsky half Century" instead of a moment (Wray, 2009).

The Economics of Minsky

Minsky criticised the main models of business cycle in US because they ignored the monetary factors. He argued that money should be included in the model of capitalist economy in which firms utilise credit. In this way inelastic supply of money becomes a factor in business model when investment is increasing causing increase in the demand for credit and resulting in high rates of interest. A fall in investment would result in reduced demand for credit and corresponding reduced interest rates (Minsky, 1954/2004; Minsky, 1957).

Minsky's Model was basically a monetary business cycle, without the complexity of say Hawtrey's model. In this model stocks are the key players in the transmission mechanism. Minsky used a Marshallian short-period equilibrium to analyse the mechanical interpretations of the accelerator principle of investment (Toporowski, 2008). In 1964, Minsky proposed his analysis of cash flow in economic units. He demonstrated their vulnerability to developments in financial market (Minsky 1964).

Around the end of 1960s, Cambridge's research on Keynes produced a series of publications that showed a relationship of Minsky's analysis with the post Keynesian approach (Minsky, 1975). He opposed the monetarist view that monetary expansion only made a transitory impact on output, the main effects were on prices. Prices were an endogenous part of the system and financial stability was affected by monetary policy. Minsky followed Kaleckian reflux theory of profit in his 'financial instability hypothesis' in which money supply was endogenous (Minsky, 1978). Furthermore, he included the notion from Irving Fisher that a boom in investment ultimately causes greater indebtedness which is the major driver if the mechanism that causes a macroeconomic financial crisis. Besides this the past and current investment fails to generate sufficient operating surplus to serve the debts incurred to obtain the investments (ibid). Minsky also proposed microeconomic counterpart for this macroeconomic crisis which became famous as shift in financing structures from hedged' to 'speculative', and from 'speculative' to 'Ponzi' financing.

Minsky concluded his views for the capitalist economic system as an obvious cause to financial instability in his book in 1986, "Stabilising an Unstable Economy". This was totally opposite to the mainstream theory of capitalism as an equilibrium system. He explained that the basic mechanism of financial crisis is the due to the unavoidable rise in indebtedness. The rate of rise in indebtedness is faster than the newer investments as they are financed by the newer debts. This causes disequilibrium between profits generated by investments and payment commitments created by the debt. The system is stable at the beginning due to the rising investment but finally collapses down because it cannot sustain the burden of the debt in relation with the cash flow (Minsky, 1986).

After 1986, Minsky analysis was buried in the analysis of industrial business cycle which he explained in his argument of financial fragility which was the product of the balance between debt and the investment financed by that debt. In his last years, Minsky emphasised on long-term view that success in financing 'money manager capitalism' encourages more debt financed investments as the techniques seemed to be fool-proof. Due to this the margins of internal funds decreases and debt-financing increases (he called this tendency for 'cushions of safety'). The financial fragility increasingly grows in the long period (Kregel, 2008).

Flaws in Minsky Model

According to Toporowski (2008), there were two basic flaws in Minsly's Model. Firstly, even if the investment is financed by the debts, Kaleckian reflux theory of profit suggests that it must increase liquidity in the balance sheets of the firms. Minsky did not address this. Secondly, the inflation in the capital market i.e. sustained growth in financial asset values tends to cause growth in equity financing instead of debt financing. This was the major factor in the long-term boom in the financial markets of UK in 1980s (at least the first part of the boom).

Furthermore Kindleberger (1989) mentioned that when firms, who are financing investments with debt and enjoying profits, realise that their indebtedness cannot be repaid from the profits being generated then they start selling their assets therefore, at best, Minsky model is rather a superficial view of market mechanism as a key factor of financial crisis because Minsky moment is psychological.

Application of Minsky Model

It is possible to use Minsky model to explain the financial crisis of 2008 by reconfiguring the essential elements of Minsly's model as well as eliminating the flaws of the model. Minsky based his model of financial instability on Fisherian two-price-system model. In this view 2008 crisis can viewed as crisis of centralised lending.

As mentioned earlier that Minsky indicated that the systems of general equilibrium that are employed to assess asset markets lack the actual process that is operating in the financial markets. The prices that equate the supply to demand are not the prices that are fixed by the markets. These markets usually operate on disequilibrium in extended periods. This causes an increase in the demand for securities up to a level that exceeds the money which both holders of the securities and the issuers are not able to take out of the market (Dimitri, 2012). Therefore the prices of the securities rise. As soon as the price for those securities rises, demand for the same rises due to the speculation of the benefit of the assets from capital gains. Here it should be noted that all securities are not same and therefore the prices of the securities are different and the rise in the prices is unequal. The price of short-term securities and bond is usually the value at which they are to be repaid within the terms mentioned.

However, not all securities are equal, and prices of securities do not rise equally. Short-term securities and bonds usually have the price at which they are repaid written. This market price tends to converge into the repayment price as the end of term approaches. Now the market price exceeds that repayment price by a small margin which reflects the difference between the interests payable those bonds and the interest payable on equivalent new issues (Kregel, 2008). The demand for new issues will increase causing inflated prices for all those equities that are not repaid on fixed values for example common stocks.

The issuers and buyers of major securities are financial intermediaries (some of them issue the others buy). Therefore, there is no net expansion of the credit in the markets and the balance sheets of non-financial businesses remain the same such as would take out of the markets any excess net inflow of money into those markets. These non-financial sectors are the corporations and the government. The ability of the government to take out finance from the markets depends upon the fiscal position of the government i.e. the difference between income and expenditure of the government (Toporowski, 2008). Similar excess of demand was seen to happen in UK and UK markets when they introduced funded pension schemes. It had a direct impact on the balance sheets operations of the corporations. The corporations that issued securities noticed in 1980s that they could issue shares at cheap rates. This is because the return on shares is not only dividends paid out of the company but capital gains are also there which are paid by the other buyer in the markets for the shares and not by the issuing company.

The reduction in the prices caused an increase in the demand for shares and the corporations issued capital more than they needed to finance their industrial and commercial operations requirement. At that time overcapitalisation could be avoided because it could have involved firstly, ‘watering down’ of profits. Watering down connotes that the profit is divided into more shareholders (Dimitri, 2012). Or secondly, probably the directors of the company loss control in a general meeting because they could not control the majority of the shares. However, most shareholders in current financial markets are institutions. They hold large diversified portfolios. Instead of getting involved in running the companies the shareholders subcontract these portfolios to specialised fund managers and they are rated on financial returns. These financial returns constitute appreciation of the value of the stocks all the way through financial inflation. Instead of the issuer of the security the return is paid by other members of the market (Dimitri, 2012). On the other hand the remuneration of the senior management are paid through new techniques in which profit-related pay is gradually being replaced by share-price related pay, using stock options. The inhibitions about the overcapitalisation of companies have been reduced by remunerations through share-price related pay along with the new techniques of managing debt.

This excess capital has served as a cheap long-term replacement of bank borrowings. It has also served as an agent to raise pre-tax profits by reducing interest cost. In case this excess of capital is not used to pay the debt it is used to buy short term financial assets or in other words it is being used to buy and sell companies (Dimitri, 2012). This is why the world has noticed long period of mergers and takeover transactions that resulted in restructure of balance sheets. 1980s are particularly categorised due to such activities.

The corporations realised that they can obtain capital from the public instead of banks and the banks lost their most important clients. Therefore banks turned to fee-related business and riskier lendings such as property market. The amount of credit increased in the housing market causing the prices rise-up. It is a paradigmatic example of asset inflation with collateral lending. The housing market became more liquid and more capital gains realised and reduced the debt induced due to the inflation in housing assets (Toporowski 2009). The inflation enhanced the quality of collateral and improved its value thus the margin between the loan and asset value increased. In 80s banks offered 80% of the asset value as mortgages which increased to 100% in 90s and few years back house purchasers in UK could obtain 120%.

The two stabilisers broke down and financial crisis began. Considering the capital market the evolution of debt-financed equity funds that were used to buy companies were transformed in to the balance sheets of the companies for the selling of the companies along with the debt and thus inflated the capital market. The trend in the equity financing converted into a trend of placing a company’s balance sheets debts. It inflated the equity market (Toporowski, 2008). On the other hand the young customers in the housing industry who in the prospect of capital gains in their middle ages, were no longer able to indebt themselves further. Therefore the housing industry broke though the capital gains would have been the greatest and it was at a point of where a ‘bubble’ may have been almost distended. The boom broke leaving the income at the lowest in the sub-prime sector of the market. The assets were least liquid and low and unreliable incomes could not serve the loans.

The financial crisis started from the breakdown of these two factors. The capital market inflated because companies were bought by the debt-financed capital and the debts were transferred to the balance sheets of these companies (Wray, 2009). The young customers in the housing market could indebt themselves up to a limit thus the boom broke where the income were lowest in the sub-prime sector of the market, the asset was least liquid and excessive debt was serviced by low incomes. The amount of credit going out of the market exceeded the amount entering the market therefore asset inflation turned into deflation.

In corporate sector, firms' investment reduced therefore the cash inflow reduced in the sector as a whole. Again the banks lost their clients, both sectors are now willing to repay debt rather than borrowing more. Now according to the Minsky financing structures, the value of asset are falling therefore financing obligations which were previously hedged by capital gains are now speculations. And these speculative structures are turned into ponzi financing structures when income and asset values are unable to produce cash flow to settle financing obligations.

Companies, households and banks acted rationally and prudently. They made their decisions on the basis of latest experience of asset inflation and subsequent deflation. The real problem ties with the mutual reinforcement of collateralised lending and asset inflation which subsequently turn in to debt deflation.

Conclusion

The discussion above shows that the situation in 2008 is not euphoria, followed by panic or hurry to sell the asset, but, it is the result of process asset inflation due to the dual price system which was indicated by Minsky which he took from Irving Fisher in a settlement of centralised lending. There must be some measures to stabilise asset values in financial reconstruction. It should not only deal with financial stability of the banking industry or the broader financial system. Minsky's analysis in combination with Fisher's debt theory is analysis relationship of finance and financial instability in an instable economy as a whole.

Regulations can be used to stabilise the financial status of the economy. For example Islamic finance offers sound stability in banking system because it takes away the economic risks from the customers and lays-off those risks to risk-sharing depositors. If the state stabilise banking system by regulations leaving the economy unaffected then during any instability (especially as in 1970s) or even in the modest imbalance, the regulations could be made lighter or removed temporarily to allow the credit system automatically alleviate those imbalances and restore the equilibrium in the system. In this arrangement no one can point any objection because it is the basic teaching of economics that the economic systems are used to address economic imbalances and they have done so effectively for many decades before latest disasters. The radical result of Minsky's work holds true that without stabilising the economy at large; stabilisation in banking is unlikely to persist.

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