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# Financial Fragility and Central Bank: Are Minsky's Crisis and Austrian Business Cycle are Complementary?

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**Abstract:** This article explains why Minsky's post-keynesian explanation tells only one side of the crisis' story. Indeed, the financial fragility of markets explains mainly the activity of Central bank i.e. the lender of last resort which increases the moral hazard phenomena and the socialization of risks. The regulated capitalism is, in this perspective, the cause of market instability and financial fragility. Indeed, moral hazard encourages commercial banks to take risks. In that respect, the economic policies implemented to manage the crisis of 2008 are inadequate.

**Keywords:** Economic crisis, Minsky, central bank, capitalism by fiat and financial instability.

## I. INTRODUCTION

The theory of capitalism's systemic weakness as suggested by Minsky (1986:Chapter 10) was very popular to explain the 2008 crisis and, more generally, economic crises of capitalist systems. In this perspective, financial instability and crises are endogenous phenomena in a capitalist economy and imply tight state intervention. This thesis is an alternative of the theory of efficient markets (Whalen 2012:12). This article shows, however that this explanation of crisis only tells one part of the story, because Minsky offers "no baseline of equilibrium competitive banking system" (White 2015) and does not explain "how the economy can enjoy a coordinated state or a period of tranquility" (Prychitko 2010:208). To this end it raises the question of the determining role of the monetary system in the level of instability of financial systems. It uses all works which illustrate the effects of central banks' actions on the moral hazard.

In Minskyian tradition financial instability is an endogenous phenomenon. At the origin of a crisis there will always be a problem of past financing and investment. A crisis for this reason is financial in nature. There is a financial crisis once current profits produced by investments do not allow facing commitments without destruction of capital and/or the sale of a part of accumulated assets. Crises in capitalist systems would be due to over-accumulation. "The economic problem is identified following Keynes as "the capital development of the economy" rather than the Knightian allocation of given resources among

alternative employments" (Minsky 1992:2). Minsky's thesis is then the following:

Initially investors are cautious. The capital and interest are repaid by the borrowers. The financial structure is called "hedge finance". In such a financing structure expected current profits are superior to commitments. The finance is healthy. A healthy capital structure that reflects a low level of debt and a corresponding high level of equity. In periods of growth and optimism on future profits, the investors are tempted however to leave this healthy financing structure. They speculate and call upon banks to refinance their debt. From healthy finance we pass on to speculative finance where the investor, to make his payments, continually staggers his debts to meet his deadlines. There is then a single step from speculative financing offered by the banks to financing based on a Ponzi system. In a Ponzi system investors are paid by funds obtained by new entries. Once the sums obtained from the new entries no longer suffice to cover client payments, the Ponzi system enters into a crisis. We enter into a financing structure *à la Ponzi* or rotten structure once current profits do not permit either to pay the interest nor the capital. The only solution the investor has is to increase his debt. This cannot be maintained indefinitely; there is a time when the banker decides not to lend anymore, which leads to a crisis.

During the 2008 subprime crisis we passed from a healthy financing structure to a Ponzi structure. The banks first sold subprime credits to solvable households and then to households less and less solvable. The risks of insolvability were then hidden by possibilities offered by debt securitization. The Minsky moment was then inevitable. This moment qualifies as the point where over indebted investors are forced to sell their assets massively to face their need for cash.

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This sets off the recession spiral. This Minskian explanation of the economic instability of capitalism inspires numerous explanations of the crisis which uphold the thesis of greed of the capital holders and ‘adventurism’ of financial institutions (Mathieu and Sterdyniak 2009<sup>1</sup>; Crotty 2009). 2008 crisis is the result of an endogenous phenomenon which is intensified by the process of financial liberalization. Economic instability is explained by the two characteristic of speculative behavior (greed and adventurism) and *in fine* the creation of bubbles disconnected from the real economy. It is because the agents are never satisfied with the margins produced by their activities that they take ever more risks and that at a given time their activities jeopardize the whole financial balance of an economy. It is a healthy financial structure toppling over to a rotten structure which explains the crisis.

A quick reading of events could make us believe that the sub-prime crisis was a Minsky moment. Aside from the internal criticism aimed at this interpretation of crises (Brossard 1998; Palley 2010) it is difficult to believe that the State, and more generally, the institutions they protect had no effect on the level of instability of contemporary capitalism. At least that is what the contemporary theory of cycles (Facchini 2004) suggests when used to explain the history of crises and the 2008 crisis in particular (White 2008; Salin 2008; Horwitz 2008; Facchini 2010; Fillieule 2010:179-180; Ravier and Lewin 2012). This aspect, often neglected by the modern theory of crises, is nevertheless fundamental if we want to understand the real origin of financial instability of modern capitalism. It is not capitalism that is unstable but capitalism regulated by States or crony capitalism. This is the thesis defended by this article. It reminds us that the subprime crisis is by definition a crisis created by the policy of access to property and support for investment (section 2) but also that the policies of public support for growth create the conditions for great risk taking by investors (Section 3). It then shows how the banks manage the risks in a free banking system (Section 4) and how the existence of a lender of last resort increases the moral hazard and *in fine* financial instability of regulated capitalism (Section 5). If the investors become adventurers it is because the State incites them. To reach towards financial

stability nothing should be expected from public regulation, on the contrary we should re-establish property rights on the monetary market. This is the prescriptive conclusion of this article (Section 5).

## II. SUBPRIME AND POLICY FOR ACCESS TO PROPERTY

Great recession of 2008 like “*most of the great catastrophes of human history have been government failures of one sort or another*” (Keech and Munger 2015:1). Indeed, the subprime crisis is by definition a crisis of regulated capitalism because the mortgage loans of subprime type are not financial products of an unregulated market economy but the products which fit into a more general policy of access to housing for the poorest social categories. This idea is not new in the United States as it originates from the time of the New Deal and the creation of the Federal Government in charge of housing (Federal Housing Administration FHA) (Robinson and Nantz 2009:9). Beginning in the 30s the FHA guaranteed the loans during the new deal of a certain number of agents when they wished to become owners of their housing.

## III. ARTIFICIAL SUPPORT FOR INVESTMENT AND MORAL HAZARD

The crisis of 2008 is also the result of a public policy support for investment. Firstly, there is an opportunity cost of subsidies. The benefits to society if the expenditure had been spent otherwise or left in the pockets of taxpayers, might have been even greater. Secondly, the subsidies benefit specific groups of people or voters. Thirdly, these policies increase the moral hazard. Moral hazard refers to the fact that people tend to engage in riskier behavior when they are insured. When the State socializes the risk of an economic activity, the firms of this sector start investing in more risky projects than normal. Money moves from industry, for instance, to agriculture. The result will be a rise of farmer loan defaults. That increases the potential instability of economic system.

In an unregulated market economy investors only take risks if the amount of profit is high and the probability of obtaining it strong enough. This anticipation rests upon subjective and objective probability, and the awareness that the future is radically uncertain. The investor acts with his own funds and for this reason remains relatively cautious. Faced with this natural caution the legislator who wants to support growth by investment can implement rules which will limit the investor’s risk and create conditions

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<sup>1</sup>The 2008 crisis is firstly explained by macroeconomic imbalances initiated by national strategies of pressure on salaries. The effects of this pressure on the salaries are not immediate as competitiveness gains (Germany or China) or the development of financialization and credit consumption delay the moment when the companies have no more openings. Mathieu Catherine and Sterdyniak Henri 2009).

for the advent of a strong moral hazard. The crisis of 2008 is also the consequence of such policies which have supported artificially the economic growth and changed the perception of risks.

Aside from the investment incentives the creation of a central bank e.g. a lender of last resort, is an important source of moral hazard and of bad investment which *in fine* leads to great financial instability. (White 2008; Salin 2008; Horwith 2009; Facchini 2010). Central bank is the lender of last resort because it offers loans to banks or other eligible institutions that are experiencing financial difficulty or are considered highly risky or near collapse. In monetary system with a lender of last resort, the safety it provides encourages the investors and banks to take more risk than necessary. The agents take risks they would not if they did not anticipate that a part of the risk was covered by the central bank and in fine the taxpayer. So while in unregulated capitalism each bank supports the costs of credit expansion in regulated capitalism with a lender of last resort each bank knows that its activities, even the most risky, are covered by the central banker who commits to helping them if these expectations prove to be errors.

#### IV. RISK TAKING IN AN UNREGULATED CAPITALISM

An unregulated capitalism is an economic system where the means of production are privately owned and operated and where the government exercises no level of control over what people can do with their property. Unregulated capitalism is not under this definition an economic system where the activities of bankers and speculator is not regulated e.g. the definition of financial liberalization. This is a free banking system. Free banking refers to a monetary arrangement in which banks are subject to no special regulation beyond those applicable to most enterprises and in which they also are free to issue their own banknotes or paper currency. In free banking system there is no lender of last resort<sup>ii</sup>.

In an unregulated capitalism and free banking system, when a banker lends money, he takes two types of risk. The first is not to be reimbursed. This was observed in the crisis of 2007/8. The holders of subprime credit no longer succeeded in paying their debt. (There was default of payment). The second type

of risk taken by a banker is to respond favorably to a request for a loan from an investor when he has no money in the bank. The banker lends more than he has in reserve. He operates a system of fractional reserves. Indeed, fractional reserve banking is a banking system in which only a fraction of bank deposits are backed by actual cash-on hand and are available for withdrawal. The banker, by a game of book entries, lends money he doesn't have and upon which he will earn interest.

In monetary system with a lender of last resort, this practice is only limited by banks' obligation to deposit a percentage of their outstanding credit with the central bank. The percentage is in reality very low. This practice has a long history, as even in a gold standard system the banker can choose to lend more money than his gold deposits. He creates paper money and takes the risk of not being able to return their gold to his clients if they insist upon being reimbursed in gold at the same time.

This risk is low in an unregulated capitalism or free banking regime for three reasons. Bankers in all institutional arrangement are tempted to use the deposit for themselves. Institutions motivate the bankers to perform these actions.. They can charge the bankers of theft and can ask them to pay interests (Hüslmann 2004). In free banking system the practice of fractional reserves is illegal. If the clients learn about it, the banker can be condemned (Huerta de Soto 2011:30). Then the bankers expect this cost by covering this risk by a compensation mechanism. Under this mechanism, any emission of paper money by a commercial bank corresponds to a deposit either in the bank that loans or in another bank which is or not specialized in bank loans (Timberlake 1984). The risk of lack of liquidity is thus limited.

Lastly it is important to remember that in a free banking system the quality of a currency depends upon the law of supply and demand (Hayek 1976). The evolution of the exchange rate between competing currencies provides information on the relative quality of the currency. A bank which gives more credit than it has in own savings or on deposit risks default. It risks devaluation of its currency and withdrawal of clients. The stockholders will always be very vigilant about such evolution as they will be the first losers in case of bankruptcy. The clients are also very attentive to the quality of the management of their bank and its practices as it is in their interest to deposit their savings in establishments that do not abuse the practice of fractional reserves.

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<sup>ii</sup>See the blog <http://www.alt-m.org>

To conclude this point we must remember that the banks do not only lend client deposits. They also lend their own funds. Bankers and their stockholders are for this reason even more vigilant when they engage their own funds. A free banking system tends then toward a system of reserves where the banker would be legally forced to not lend more than he has on deposit and where he would be forced by his competitors and his stockholders (spurred on by the financial market) to watch the quality of his money.

## V. CENTRAL BANK AND FRAGILISATION OF FINANCIAL SYSTEM

In an institutional arrangement with a lender of last resort, the bankers' economic calculation is modified. The dissemination of the fractional reserve practice and the safety given by the socialization of risks lead moral hazard and *in fine* easy money and soft budgets (Mueller 2001:6). The consequence is financial instability (Selgin 2010).

The risk of not being reimbursed is less common in a system where the government supports investment. The fact that loans are implemented and supported by the government and more generally that all the big American banks such as Fannie Mae, Freddie Mac, are linked to the government by charters which enable government to give them missions which in exchange are remunerated by privileges (Robinson and Nantz 2009; Horwitz 2009:11; Prychitko 2010:219) explains why the big banks become less cautious. They know that the responsibility for a payment crisis is shared with the government which has the power in serious crises to use such force, otherwise stated its power to raise taxes, to restore the financial balance of the economy's financing system. Fannie and Freddie "are not "free market" firms (Horwitz 2009:11) and have the status of "Big Players" (Koppl 2001). Central bank is a Big Player. It enjoys the discretionary power to influence markets while being immune from the profit and loss, reward and punishment process" (Prychitko 2010:219). It encouraged speculative and Ponzi-financed investment and caused moral hazards. Financial instability is amplified and exacerbated by credit expansion or the "easy money" policy of central bankers (Mulligan, Lirely and Coffee 2014).

The risk of a bank's lack of liquidity is also greater in a regulated capitalism. On the one hand because the practice of fractional reserve is legal (Huerta de Soto 2011), on the other because private compensation chambers are replaced by a bureaucratic organization

whose interests are very different from those of a private banker. And finally, because the legal rate prevents the law of supply and demand from putting pressure on the money producers to limit their risk.

The legalization of the fractional reserve banking allows banks to issue multiple receipts for the exact same reserve. Similar to a Ponzi dynamic, banks lend a money they don't have. This is one origin of the financial instability. Fractional reserve banking creates an easy money context. New money devaluates existing money and creates inflationist tensions. Inflation is the first factor of financial instability. When people understand that their deposits are not really there. They demand their deposits. That induces a deflationist pressure and in fine a potential bust. Central bank can expect this impact and enforce a zero interest rate policy. The consequence of this policy of easy money is over liquidity, meaning too much dollar or euro. The securitization is a first strategy to withdraw from the market the credit they have created and to reduce the inflationist pressure. Securitization hides monetary inflation. All these consequences distort price information and increase strongly the cost of coordination in regulated capitalism.

In regulated capitalism private compensation chambers are replaced by a bureaucratic organization or a political procedure. Central bank introduced 'a discretionary political element into monetary decision making and thereby divorced the authority determining the system's behavior from those who had a self-interest in maintaining its integrity' (Timberlake 1984:14-15). Central banker has his/hers own motivations, which do not necessarily slow down the bankers' risk taking. The central banker is not, firstly, responsible on its own funds as is the banker who covers another banker. It uses public funds from taxes. The fiscal constraint is, secondly, less immediate than the financial constraint. The State can at any time use its power of coercion to refinance its banks. It can be politically sanctioned for having increased fiscal pressure, but this sanction is less immediate and less severe than that of a banker who cannot be paid by his colleague. He would be ruined and this sanction would be immediate and certain.

The legal rate renders captive all individuals who reside on a territory. A payment method has a legal rate within a territory if no one can refuse it in payment of a debt written in the same monetary unit. The agent is then unable to refuse a currency that he feels is of

insufficient quality. He cannot refuse a salary written in this currency, etc. He is captive of the currency chosen by the central banker. This risk is even greater when, as a last resort lender, the central banker creates a phenomenon of moral hazard (Carilli and Dempster 2001:322). In a system with a central bank the bank is encouraged to practice partial coverage as it knows that in case of bank panic or crisis everyone will be required to pay for the crisis. The State will increase taxes, and the central banker will facilitate the refinancing of the banks in difficulty. A virtuous bank would not use a means of exploiting profit opportunities created artificially by legislation of the practice of fractional reserves but would be sure on the other hand to pay the costs *via* taxation and/or weak interest rates proposed by the banks who do not try to adjust their loans to their deposits. It is the survival of a bank which does not develop the practice of partial coverage which is at risk.

## VI. CONCLUSION

The objective of this short article is not to uphold that the capitalist financial system is perfectly stable but that it is not fair to link financial instability and unregulated capitalism. Unregulated capitalism is not perfectly stable or efficient, because market process is a "dynamic rivalrous process that unfolds through time" (Klein and Klein 2001:6). It is the result of the entrepreneurial activity and it is, for this reason, unpredictable and inherently imperfect. It is a process of essay error and stabilization where recession has a cleaning effect. It allows for capital to be reallocated to relatively more productive firms which lead to higher productivity on average and to higher output in the economy. Instability in unregulated capitalism is, for this reason virtuous. It is the sign that entrepreneurs learn and tries to discover perpetually the preference of consumers.

Regulated capitalism is also instable. But this instability is the symbol of government failure and of decisions of monetary authorities. Indeed, if the aim of Central Bank and government intervention is to stabilize economic system, instability is a failure. This paper has showed why financial fragility of American and developed countries capitalism finds its explanation, on the one hand, by the existence of central banks and on the other by government support policies for investment. Excessive debt and excessive investment at the origin of the Minsky moment originates from the activity of the lender of last resort.

The other particularity of the instability in regulated capitalism is the role of bust. Bust in this institutional arrangement has the same cleaning mechanism, the bankruptcy of firms. Easy money, nonetheless, induces rents or artificial profits. Then, regulated capitalism can protect the rent of banks and all the cronies of bankers. Regulated capitalism is a crony capitalism where big-players use the coercion power of State to limit the negative consequences of competition on their interest. The effect of these coalition between Government and firms is a selection bias. The profit and loss system is now a rent (artificial profit), profit and loss. Rivalrous process can protect rent and sort-out the good entrepreneurs. The impact of very important on the dynamic of capitalism and the structure of capital.

If public intervention encourages financial instability of regulated capitalism, more State is not the solution. The governments should refrain from intervening in the corrective process of recession (Horwitz 2009:14 and 18). The solution is a longer-term institutional one (Horwitz 2009:19; Salin 2010). It is, on the other hand, to establish private property right in monetary matters to limit the phenomenon of moral hazard and more precisely the practice of fractional reserves. In this perspective, the institutional change should 1- to restore the reserve coefficient of 100%, 2- to give gold its role back and 3- to break up the central banks (Huerta de Soto 2011:Chapter 9).

These solutions have never been considered by political authorities who think that the origin of financial instability is unregulated capitalism and neo-liberal policies of the 90s. (Blot and al. 2009; Naszalyi 2012; Nakatani and Herrera 2013). As Minsky (1986) upheld, governments instead reinforced the role of the bank and the constraints written in the existing financial regulations, engaged measures to reduce speculative behavior and banks' off shore activities (Cartapanis 2009, 2011) and put active budgetary and monetary policies in place to support economic growth. We know though that the prudential rules come into contradiction with the insurance mechanisms put into place by the central banks. Fixing a minimum level of own funds without asking what that means in terms of risk leads to the making of an arbitrary decision (Janson 2011). Faced with this arbitrary the banks try to go around the regulations and are encouraged by a system favorable to risk taking. A portion of financial innovations which favor financial instability thus find their origin in the public prudential rules. We also know that support policies on demand increasing public spending have,

above a certain level of public spending, negative effects (Facchini and Melki 2013). The non-linearity of the relationship public spending-growth in production renders the positive effects of public spending on stability and production levels very hypothetical.

The totality of these solutions rests on a bad diagnosis and leads to maintaining an artificial growth model which lengthens the time and the depth of the recession (Mises 1977:365-366).

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