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The Limits of Minsky's Financial Instability Hypothesis as an Explanation of the Crisis

Thomas Palley

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Abstract

The financial crisis has been widely interpreted as a Minsky crisis. This paper argues that interpretation is misleading. The processes identified in Minsky's financial instability hypothesis played a critical role in the crisis, but that role was part of a larger economic drama involving the neoliberal growth model.

The neoliberal model inaugurated an era of wage stagnation. In place of wage growth spurring demand growth, it relied on borrowing and asset price inflation. That arrangement was always unsustainable but financial innovation and deregulation warded off the model's stagnationist tendencies far longer than expected. These delay mechanisms is where Minsky's financial instability hypothesis enters the narrative.

The interpretation of the financial crisis and Great Recession has enormous significance for economic policy. If interpreted as a purely financial crisis, in the spirit of a pure Minsky crisis, the policy implication is simply to fix the financial system. However, there is no need for reform of the real economy because that is not the source of the problem.

If instead, the crisis is interpreted through a new Marxist – Structural Keynesian lens the policy implications are deeper and more challenging. Financial sector reform remains needed to deal with the problems of destabilizing speculation and political capture. However, it does not address the root problem which is the neo-liberal growth model.

Restoring stable shared prosperity requires replacing the neoliberal model with a new model that restores the link between wage and productivity growth. That will require adoption of a new labor market agenda, re-fashioning globalization, reversing the imbalance between market and government, and restoring the goal of full employment.

Financial sector reform without reform of the neoliberal growth model will leave the economy stuck in an era of stagnation. That is because stagnation is the logical next step of the neoliberal model given current conditions. Ironically, financial sector reform alone may worsen stagnation since financial excess was a major driver of the neoliberal model and that driver would be removed.

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I Minsky's moment

Aside from Keynes, no economist seems to have benefitted so much from the financial crisis of 2007/8 as the late Hyman Minsky. The collapse of the sub-prime market in August 2007 has been widely labeled a “Minsky moment”, and many view the subsequent implosion of the financial system and deep recession as confirming Minsky’s “financial instability hypothesis” (Ferri and Minsky, 1992; Minsky, 1993) regarding economic crisis in capitalist economies.

For instance, in August 2007, shortly after the sub-prime market collapsed, the *Wall Street Journal* devoted a front page story to Minsky (Lahart, 2007). In November 2007, Charles Calomiris, a leading conservative financial economist associated with the American Enterprise Institute, wrote an article for the *Vox EU* blog of the mainstream Center for Economic Policy Research claiming a Minsky moment had not yet arrived. Though Calomiris disputed the nature of the moment, Minsky and his heterodox ideas were the focal point of the analysis. In September 2008 Martin Wolf of the *Financial Times* openly endorsed Minsky: “What went wrong? The short answer: Minsky was right”. And in May 2009, *New York Times* columnist and Nobel Prize winning economist Paul Krugman posted a blog titled “The night they reread Minsky”, which was also the title of his third Lionel Robbins lecture at the London School of Economics.

II Does Minsky's theory really explain the crisis?

Recognition of Minsky’s intellectual contribution is welcome and deserved. Minsky was a deeply insightful theorist about the proclivity of capitalist economies to financially driven booms and busts, and the crisis has confirmed many of his insights.

That said, the current paper argues his theory only provides a partial and incomplete account of the current crisis.

In making the argument, the paper focuses on competing positions among progressive economists regarding explanation of the crisis. On one side, Levy Institute economists Jan Kregel (2007, 2008a, 2008b), Charles Whalen (2007), and Randall Wray (2007, 2008, 2009) have argued the economic crisis constitutes a classic Minsky crisis, being a purely financial crisis that is fully explained by Minsky's financial instability hypothesis. On the other side are the new Marxist view of Foster and McChesney (2009), the social structure of accumulation (SSA) view of Kotz (2009), and the structural Keynesian view of Palley (2008a, 2009). These latter views interpret the crisis fundamentally differently, tracing its ultimate roots back to developments within the real economy.

The new Marxist, SSA, and structural Keynesian views trace the roots of the crisis back to the adoption of the neoliberal growth model in the late 1970s and early 1980s when the post-World War II "Treaty of Detroit" growth model was abandoned.¹ The essence of the argument is that the post-1980 neoliberal growth model relied on rising debt and asset price inflation to fill the hole in aggregate demand created by wage stagnation and widened income inequality. Minsky's financial instability hypothesis explains how financial markets filled this hole and filled it for far longer than might reasonably have been expected.

¹ The treaty of Detroit refers to the five year wage contract negotiated by the United Autoworkers union with Detroit's big-three automakers in 1950. That contract symbolized a new era of wage setting in the US economy led by unions in which wages were effectively tied to productivity growth.

Viewed from this perspective, the mechanisms identified in Minsky's financial instability hypothesis are critical to understanding the neoliberal era, but they are part of a broader narrative. The neoliberal model was always unsustainable and would have ground to a halt of its own accord. The role of Minsky's financial instability hypothesis is to explain why the neoliberal model kept going far longer than anticipated.

By giving free rein to the Minsky mechanisms of financial innovation, financial deregulation, regulatory escape, and increased appetite for financial risk, policymakers (like former Federal Reserve Chairman Alan Greenspan) extended the life of the neoliberal model. The sting in the tail was this made the crisis deeper and more abrupt when financial markets eventually reached their limits. Without financial innovation and financial deregulation the neoliberal model would have got stuck in stagnation a decade earlier, but it would have been stagnation without the pyrotechnics of financial crisis.

This process of financial innovation and deregulation expanded the economic power and presence of the financial sector and has been termed "financialization" (see Palley 2008b). Financialization is the concept that marries Minsky's ideas about financial instability with new Marxist and structural Keynesian ideas about demand shortage arising from the impact of neo-liberal economic policy on wages and income inequality.

The interpretation placed upon the crisis matters enormously for policy prescriptions in response to the crisis. If the crisis was a "pure" Minsky crisis all that is needed is financial re-regulation aimed at putting speculation and excessive risk-taking back in the box. Ironically, this is the approach being recommended by Treasury Secretary Geithner and President Obama's chief economic counselor, Larry Summers.

Their view is financial excess was the only problem and normal growth will return once that problem is remedied.

The new Marxist – SSA - structural Keynesian “financialization” interpretation of the crisis is far more pessimistic. Financial regulation is needed to ensure economic stability, but it does not address the ultimate causes of the crisis and nor will it restore growth with full employment. Indeed, paradoxically, financial re-regulation could even slow growth because easy access to credit was a major engine of the neoliberal growth model. Taking away that engine while leaving the model unchanged therefore promises even slower growth.

III Minsky’s financial instability hypothesis

Minsky’s financial instability hypothesis maintains that capitalist financial systems have an inbuilt proclivity to financial instability. That proclivity can be summarized in the aphorism “Success breeds success breeds failure” - or better still, “success breeds excess breeds failure”.

Minsky’s framework is one of evolutionary instability and it can be thought of as resting on two different cyclical processes. The first cycle can be labeled the “basic Minsky cycle”, while the second can be labeled the “super-Minsky cycle”.

The basic Minsky cycle concerns the evolution of patterns of financing arrangements and it captures the phenomenon of emerging financial fragility in business and household balance sheets. The cycle begins with “hedge finance” when borrowers’ expected revenues are sufficient to repay interest and loan principal. It then passes on to “speculative finance” when revenues only cover interest. Finally, the cycle ends with

“Ponzi finance” when revenues are insufficient to cover interest payments and borrowers are relying on capital gains to meet their obligations.

The basic Minsky cycle offers a psychologically based theory of the business cycle. Agents become progressively more optimistic, which manifests itself in increasingly optimistic valuations of assets and associated revenue streams and willingness to take on increasing risk in belief that the good times are here forever. This optimistic psychology afflicts both borrowers and lenders and not just one side of the market. That is critical because it means market discipline becomes progressively removed.

This process of rising optimism is evident in the way business cycle expansions tend to foster talk about the “death of the business cycle”. In the 1990s there was talk of the “new economy” that was supposed to have killed the business cycle by inaugurating a period of permanently accelerated productivity growth. In the 2000s there was talk of the “Great Moderation” that claimed central banks had tamed the business cycle through improved monetary policy based on improved theoretical understanding of the economy. This talk is not incidental but instead constitutes evidence of the basic Minsky cycle at work. Moreover, it afflicts all, including regulators and policymakers. For instance, Federal reserve Chairman Ben Bernanke (2004) was himself a believer in the Great Moderation hypothesis.

The basic Minsky cycle is present every business cycle. It is complemented by the super-Minsky cycle that works over a period of several business cycles. This super-cycle is a process that transforms business institutions, decision-making conventions, and the

structures of market governance including regulation. These structures are critical to ensuring the stability of capitalist economies and Minsky (Ferri and Minsky, 1992) called them “thwarting institutions”.

The process of erosion and transformation takes several basic cycles, making the super-cycle a long phase cycle relative to the basic cycle. Both operate simultaneously so that the process of institutional erosion and transformation continues during each basic cycle. However, the economy only undergoes a full-blown financial crisis that threatens its survivability when the super-Minsky cycle has had time to erode the economy’s thwarting institutions. In between these crises the economy experiences more limited financial boom - bust cycles. Once the economy has a full scale crisis it enters a period of renewal of thwarting institutions – a period of creating new regulations such as the current moment.

Analytically, the super-Minsky cycle can be thought of as allowing more and more financial risk into the system. The cycle involves twin developments of “regulatory relaxation” and “increased risk taking”. These developments increase both the supply of and demand for risk.

The process of regulatory relaxation has three dimensions. One dimension is regulatory capture whereby the institutions designed to regulate and reduce excessive risk-taking are captured and weakened. That process has clearly been evident the past twenty-five years during when Wall Street stepped up its lobbying efforts and established a revolving door with regulatory agencies such as the Federal Reserve, the Securities and Exchange Commission, and the Treasury Department.

A second dimension is regulatory relapse. Regulators are human and part of society, and like investors they are subject to memory loss and reinterpretation of history. Consequently, they too forget the lessons of the past and buy into rhetoric regarding the death of the business cycle. The result is willingness to weaken regulation on grounds that things are changed and regulation is no longer needed. These actions are supported by ideological developments that justify such actions. That is where economists have been influential through their theories about the “Great Moderation” and the viability of self-regulation.

A third dimension is regulatory escape whereby the supply of risk is increased through financial innovation that escapes the regulatory net because the new financial products and practices were not conceived of when existing regulation was written.

The processes of regulatory capture, regulatory relaxation, and regulatory escape are accompanied by increased risk taking by borrowers. First, financial innovation provides new products that allow borrowers to take on more debt. One example of this is home equity loans; another is mortgages that are structured with initial low interest rates that later jump to a higher rate.

Second, market participants are also subject to gradual memory loss that increases their willingness to take on risk. Thus, the passage of time contributes to forgetting of earlier financial crisis, which fosters new willingness to take on risk, The 1930s generation were cautious about buying stock, but baby boomers became keen stock investors.

Changing taste for risk is also evident in cultural developments. An example of this is the development of the “greed is good” culture epitomized by the fictional character Gordon Gecko in the movie *Wall Street*. Another example is the emergence of investing as a form of entertainment, reflected in phenomena like day trading; the emergence of TV personalities like Jim Cramer; and changed attitudes toward home ownership that became interpreted as an investment opportunity as much as providing a place to live.

Importantly, changed attitudes to risk and memory loss also affect both sides of the market (i.e. borrowers and lenders) so that market discipline becomes an ineffective protection against excessive risk-taking. Borrowers and lenders go into the crisis arm in arm.

The theoretical framework behind the financial instability hypothesis is elegant and appealing. It incorporates institutions, evolutionary dynamics, and the forces of self-interest and human fallibility. Empirically, it appears to comport well with developments over the past thirty years. During this period there were three business cycles (1981 – 1990, 1991 – 2001, and 2002 – 2009). Each of those cycles was marked by a basic cycle in which borrowers and lenders took on increasingly more financial risk. Additionally, the period as a whole was marked by a super-cycle involving financial innovation, financial deregulation, regulatory capture, and changed investor attitudes to risk.

For Minsky proponents, like Kregel (2007, 2008a, 2008b), Whalen (2007), and Wray (2007, 2008, 2009), the financial instability hypothesis appears to give a full and complete account of the crisis. Over the past twenty-five years there was a massive

increase in borrowing and risk-taking that increased financial fragility at both the individual and systemic level. The operation of the Minsky super-cycle gradually eroded the thwarting institutions that protected the system, and that allowed a housing bubble that engulfed the banking system in a full blown Ponzi scheme and also spawned related reckless risk-taking on Wall Street. This structure crashed when house prices peaked in mid-2006 and the sub-prime mortgage market imploded in 2007.

III New Marxist, SSA, and structural Keynesian interpretations of the crisis

A Minskyian interpretation of the crisis leads to an exclusive focus on financial markets. In contrast, new Marxist (Foster and McChesney, 2009), SSA (Kotz, 2009) and structural Keynesian (Palley, 2008a, 2009) interpretations believe the crisis has deeper roots located in the real economy.

Foster and McChesney (2009) adopt a Baran – Sweezy (1966) monopoly capital mode of analysis to explain the crisis, arguing the crisis represents a return of the historical tendency to stagnation within capitalist economies. Kotz (2009) adopts a SSA mode of analysis that has strong similarities with the Foster – McChesney approach. For both, the crisis represents a surfacing of the contradictions within the neoliberal regime of growth and capital accumulation caused by three decades of wage stagnation and widening income inequality. Finance is visibly present in the crisis because the expansion of finance played a critical role supporting demand growth and countering stagnationist tendencies within the neoliberal model.

The structural Keynesian argument developed by Palley (2008, 2009) has many similarities to the new Marxist and SSA approaches, particularly regarding the

significance of the shift to neoliberalism in the late 1970s and early 1980s. The Keynesian dimension is the explicit focus on aggregate demand, which is the funnel by which the structural changes associated with neoliberalism affect the economy.

Parenthetically, what distinguishes structural Keynesianism from the “old Keynesianism” of economists like James Tobin and Paul Davidson is the inclusion of class conflict effects. Old Keynesians are also interested in financial instability and problems of demand shortage but their analysis ignores income distribution effects on aggregate demand arising from class conflict.

As with the new Marxist and SSA accounts, finance plays a critical role in the structural Keynesian account by maintaining demand via debt and asset price inflation in place of wage growth. However, there are two additional features to the structural Keynesian account.

One is its identification of and emphasis on the functional significance of financial innovation and deregulation in fuelling demand growth. This provides the channel for incorporating Minsky’s financial instability hypothesis into a broader synthetic explanation of the crisis.

The second is its identification of the trade deficit and the flawed US model of global economic engagement in causing the crisis. This role concerns not only wage squeeze effects, but also the effects of draining demand out of the US economy. The flawed model of US global economic engagement created a triple hemorrhage of leakage of spending on imports, off-shoring of jobs, and off-shoring of new investment. This

triple hemorrhage accelerated the stagnationist proclivities inherent in the neoliberal growth model, thereby helping bring on the crisis.

IV.a Neoliberalism and the roots of the crisis

A central feature common to new Marxist, SSA, and structural Keynesian analyses concerns the adoption of the neoliberal growth model around 1980. That shift initiated a thirty year period of wage stagnation and widened income inequality, and both narratives trace the roots of the crisis back to this change of economic paradigm.

Pre-1980, economic policy was committed to full employment and wages grew with productivity – the so-called “Treaty of Detroit” model. This configuration created a virtuous circle of growth. Wage growth tied to productivity meant robust aggregate demand that contributed to full employment. Full employment provided an incentive to invest which in turn raised productivity, supporting higher wages.

Post-1980, economic policy retreated from commitment to full-employment and helped sever the link between productivity growth and wages. In place, policymakers established a new neoliberal growth model that was fuelled by borrowing and asset price inflation which became the engines of aggregate demand growth in place of wage growth.

The results of the neoliberal model, now well documented (see Mishel et al, 2008), were widening income inequality and detachment of worker wages from productivity growth. The severing of the wage – productivity link was brought about by substituting concern with inflation in place of full employment; attacking unions, labor

market protections, and the minimum wage; and placing US workers in international competition via globalization.

Economic policy played a critical role in generating these outcomes, with policy weakening the position of workers and strengthening the position of corporations. These new policies can be described in terms of a pen that fenced workers in. The four sides of the pen are globalization, labor market flexibility, small government, and abandoning full employment.

Globalization promotes the internationalization of production that puts workers in international competition. Attacks on the legitimacy of government push privatization, deregulation, and a tax cut agenda that worsens income inequality and squeezes government spending and public investment. The labor market flexibility agenda attacks unions and labor market supports such as the minimum wage, unemployment benefits, employment protections, and employee rights. The adoption of inflation targeting places concern with inflation ahead of full employment, and it also turns over to financial interests the management of central banks and monetary policy (Palley, 1997).

Finally, the Washington Consensus development policy pushed by the World Bank and IMF spread the neoliberal agenda globally, thereby multiplying its impact by having all countries adopt it. That imposed a wage squeeze in all countries and also multiplied the force of wage competition and deregulatory across countries.

IV.b How Minsky fits into the new Marxist – SSA – structural Keynesian account

There is also another critical element to the neoliberal model that was initially entirely over-looked by SSA theorists (Bowles et al., 1983; Gordon, 1996). That element

is debt and financial boom. In contrast to SSA theorists, new Marxists (Sweezy and Magdoff, 1978a, 1978b) recognized the significance of debt but they failed to recognize the ability of the financial system to keep expanding the supply of credit, which is why they were perplexed by neo-liberalism's longevity. This is where Minsky's thinking becomes so important, as it explains the ability to expand credit. It also adds financial instability into the brew of stagnation.

Debt provides consumers with a means of maintaining consumption despite stagnant wages and widened income inequality, while financial boom provides consumers and firms with collateral to support further debt-financed spending. These critical roles of debt and financial boom in turn provide the avenue for embedding Minsky's financial instability hypothesis within the new Marxist, SSA, and structural Keynesian narratives.

The neoliberal growth model has a logic that begins with redirecting income from workers to upper income management and profits. Workers then maintain consumption despite stagnant wage income by borrowing, while the non-financial corporate sector promotes financial boom via stock buy-backs and leveraged buyouts. Not only does that raise stock prices, it also transfers funds to households. These practices explain rising household and corporate indebtedness measured respectively as debt-to-income and debt-to-equity ratios, and increased indebtedness explains the shift of profits toward the financial sector.

Borrowing is facilitated and expanded by financial innovation and financial deregulation, which become essential to keeping the system going. Thus, not only does

neoliberalism ideologically support financial de-regulation, it also needs it functionally.

Together, financial innovation and deregulation ensure a steady flow of new products that allow increased leverage and widen of the range of assets that can be collateralized. Such products include home equity loans, exotic mortgages such as zero-downs, and the shift to 401(k) pension plans that can be borrowed against.

House price inflation plays an especially important role since higher home values provide collateral that can be borrowed against. That makes financial innovations and deregulation that increases the availability of housing finance especially important because increased supply of housing finance increases house prices. It also explains why house price inflation correlates so strongly with economic expansion in the neoliberal era (Palley, 2009).

However, this dynamic remains intrinsically unsustainable as it relies on rising debt and house prices at the same time that ordinary household income is being squeezed. Once households are unable to borrow further owing to hitting borrowing limits or owing to an end to house price inflation, the system quickly stops. That is what happened with collapse of the housing bubble that provided households with the equivalent of a personal ATM and also spurred a construction boom.

Minsky's financial instability hypothesis is a critical part of the narrative because it explains why the neo-liberal growth model was able to avoid stagnation for so long. The processes of financial innovation, deregulation, regulatory escape, and increased appetite for risk enabled the financial system to raise debt ceilings and expand the

provision of credit. That had two critical effects. First, it extended the lifespan of the neoliberal model enabling it to maintain a patina of prosperity.

Second, since these processes increased indebtedness and leverage, the crisis was far more severe when it finally occurred. Absent, twenty-five years of debt-fuelled growth and debt-financed asset price inflation, the neoliberal model would have succumbed to creeping stagnation. Instead, the processes identified in Minsky's financial instability hypothesis staved off stagnation, but when these financial processes finally exhausted themselves the result was a financial crash of historic proportions. That explains why the current stagnation (which many mainstream economists now appear to be signing on to) was initiated with a major financial crisis.²

Such reasoning renders Minsky's financial instability hypothesis fully consistent with the new Marxist - SSA - structural Keynesian perspective on the crisis. Indeed, the historical record cannot be explained without it. However, the grave danger is the crisis will be interpreted as a purely financial crisis and its neoliberal roots over-looked. Avoiding that pitfall requires recognizing the crisis only took the form of a financial crisis because financial excess was used to keep at bay neoliberalism's tendency to stagnation.

IV.b Flawed US global economic engagement and the crisis

² Many leading mainstream economists are now predicting an extended period of stagnation. Lawrence Summers (New York Times, October 1, 2009) in a speech to the National Association for Business Economics declared "we need to recognize that lack of demand will be a major constraint on output and employment in the American economy for the foreseeable future". Harvard Professor and former IMF Chief Economist, Ken Rogoff (2009) has written about the "new normal" for growth being "a notably lower average growth rate than they enjoyed before the crisis." And Paul Krugman (2009) has written "the job market will remain terrible for years to come".

A second feature distinct to the structural Keynesian narrative concerns the flawed US model of global engagement. Both the new Marxist and structural Keynesian accounts of the crisis attribute a role to globalization through its impact on squeezing wages. However, reflecting its Keynesian dimension, the structural Keynesian account gives an additional important role to the trade deficit and off-shoring through their impact on aggregate demand.

According to the structural Keynesian narrative (Palley, 2009) the neoliberal growth model might have gone on quite a while longer were it not for flawed US international economic policy. That policy accelerated the undermining of the real economy by further undermining income and employment necessary to support borrowing and asset price inflation.

During the 1990s the Clinton administration cemented a new corporate model of globalization with NAFTA (1994), establishment of the WTO (1996), adoption of a “strong dollar” policy after the East Asian financial crisis (1997), and granting China permanent normal trading relations (2000). These measures delivered the model of globalization that corporations and their Washington think-tank allies had lobbied for. The irony is when they got what they wanted the result was to undermine neo-liberal model at warp speed.

This is because the new globalization model created a “triple hemorrhage”. The first hemorrhage was leakage of spending on imports. Spending therefore drained out of the economy creating incomes offshore rather than in US, but borrowing kept adding to debt burdens.

The second hemorrhage was leakage of jobs out of US economy. This leakage was driven by the process of off-shoring made possible by the new model of globalization made possible. This job loss directly undermined household incomes. Moreover, even when jobs did not move offshore, the threat of off-shoring was used to suppress wages and that lowered income and undermined the ability to borrow (Bronfenbrenner, 2000; Bronfenbrenner and Luce, 2004).

The third hemorrhage concerns new investment. Not only were existing plants closed and off-shored, new investment was also diverted offshore. That imposed double damage since the US lost both the jobs that would have come with building new plants and the jobs that would have been created to operate those plants.

This triple hemorrhage was the inevitable result of the corporate model of globalization, the goal of which was never to create a global market in which corporation could sell US products. Instead, the goal was to create a global production zone in which corporations could produce and export to the US. Given this goal, it was inevitable the US would suffer persistent growing trade deficits, off-shoring of employment, and diversion of investment.

The new model also explains why corporations supported the strong dollar policy since it lowered the cost of goods imported into the US. That raised corporate profit margins since companies continued charging dollar prices on Main Street while importing inputs and products paid for with under-valued foreign currency.

Lastly, the flawed US model of global economic engagement also helps explain the global nature of the crisis. Thus, developing countries embraced the US model of

global economic engagement since it allowed them to pursue export-led growth policies. The US model of globalization encouraged investment and transfer of manufacturing know-how to developing countries. Furthermore, the US policy of a strong dollar fit with developing countries who wanted undervalued currencies in order to maintain competitive advantage.

The net result was developing countries enjoyed ten years of fast export-led growth during which they ran large trade surpluses, built up large foreign exchange holdings, and received large inflows of foreign direct investment. However, the new system had the global economy effectively flying on one engine with its fate tied to the US economy and the US consumer in particular. When the US economy crashed with the bursting of the house price bubble, it pulled down the global economy too. Far from creating a de-coupled global economy as claimed by many economists, the system was significantly linked and exhibited a concertina effect whereby other economies came crashing in behind.

IV Conclusion: why interpretation matters

The financial crisis and Great Recession that began in 2007 have been widely interpreted as a Minsky crisis. This paper has argued that such an interpretation is misleading. The processes identified in Minsky's financial instability hypothesis played a critical role in the crisis, but that role was part of a larger economic drama involving the neoliberal growth model that was implemented around 1980.

The neoliberal growth model inaugurated an era of wage stagnation and widened income inequality. In place of wage growth to spur demand growth, it relied on

borrowing and asset price inflation. That arrangement was always unsustainable but the combination of financial innovation, financial deregulation, regulatory escape, and increased appetite for financial risk warded off the model's stagnationist tendencies far longer than expected. Bubbles and debt ceilings are hard to predict, which is why critics of the model were early in their predictions of its demise (see for instance Palley, 1998, chapter 12).

These delay mechanisms is where Minsky's financial instability hypothesis enters the narrative. However, keeping the model going via rising indebtedness and asset price bubbles meant the crash was far larger and took the shape of an abrupt financial crisis when the process eventually ran out of steam.

IV.a Policy implications

At this juncture the interpretation of the financial crisis and Great Recession has enormous significance for economic policy. If the crisis is interpreted as a purely financial crisis, in the narrow spirit of Minsky's financial instability hypothesis, the policy implication is to fix the financial system through reforms addressing excess leverage, excess risk-taking, inadequate capital requirements, and badly designed incentive pay arrangements for bankers and financiers. However, there is no need for reform of the real economy because that is not the source of the problem.

Such an interpretation generates policy recommendations similar to those of Larry Summers and Treasury Secretary Geithner. That is also the view of Simon Johnson (Johnson, 2009; Johnson and Kwak, 2009), a former IMF chief economist, who has also focused on the political power of the Wall Street lobby and the problem of regulatory

capture. Ironically, this places Minsky, who was always a heterodox thinker, in the most orthodox policy company.

If instead, the crisis is interpreted through a new Marxist - SSA - Structural Keynesian lens the policy implications are deeper and more challenging. Financial sector reform remains needed to deal with the problems of destabilizing speculation, political capture, excessive pay, and misallocation of resources. However, financial sector reform will not address the root problem which is the neoliberal growth model.

Restoring stable shared prosperity requires replacing the neoliberal growth model with a new model that restores the link between wage and productivity growth. That will require adoption of a new labor market agenda, re-fashioning globalization, reversing the imbalance between market and government, and restoring the goal of full employment.

Financial sector reform without reform of the neoliberal growth model will leave the economy stuck in an era of stagnation. That is because stagnation is the logical next step of the neoliberal model given current conditions. Indeed, financial sector reform alone may worsen stagnation since financial excess was a major driver of the neoliberal model and that driver would be removed.

IV.b Minsky's relationship with SSA theorists and new Marxists

Reflection upon the crisis also helps understand some of the splits that afflicted progressive economics in 1970s and 1980s. Minsky's financial instability hypothesis represents capitalist crisis as a purely financial phenomenon driven by proclivity to speculation and excessive optimism on the part of borrowers and lenders. This contrasts

with the orthodox Marxist position that interprets stagnation as a real phenomenon driven by the falling rate of profit due to rising capital intensity.

It also contrasts with the early SSA position that focused initially on the problem of full employment profit squeeze and then on the problem of neoliberal wage-squeeze and effort exploitation (Bowles et al., 1983; Gordon, 1996). Like orthodox Marxism, early SSA theory also interpreted stagnation as a purely real phenomenon, being due to lack of aggregate demand caused by worsened income distribution. Consequently, there was a fundamental intellectual antipathy between Minsky's purely financial interpretation of crisis and SSA's initial purely real economy interpretation.

The new Marxist (Sweezy and Magdoff, 1978a, 1978b) interpretation sits in between, recognizing the role of real economy forces and also giving a role to debt as a means of sustaining the cycle. However, it failed to incorporate the mechanisms of Minsky's financial instability hypothesis.

Structural Keynesianism offers a synthesis of these points of view. First, it shares the generic Marxist point of view that there is an underlying real economy problem regarding wage squeeze and deterioration of income distribution, which ultimately gives rise to a Keynesian aggregate demand problem. This is where the great Polish economist Michal Kalecki is so important as his framework provides the bridge between Keynesian and new Marxist logic.

Second, structural Keynesianism recognizes that finance played a critical role in sustaining the neo-liberal regime by fuelling asset price inflation and borrowing which filled the demand gap created by the wage squeeze. That recognition opens the way for

incorporating Minsky's financial instability hypothesis, with financial excess being the way that neoliberalism staved off its stagnationist tendency. This in turn explains why the crisis took the form of a financial crisis when it eventually arrived. However, the reality is financial excess was always a patch on the underlying real economic contradiction.

IV.c The crisis and progressive economics

The above analysis shows the new Marxist, SSA, and structural Keynesian accounts of the crisis share many similarities. Most importantly they all identify need to reverse neoliberalism and restore the link between wages and productivity growth. That raises questions as to what are the fundamental differences, if any.

Orthodox Marxists believe crisis results from a falling rate of profit due to a rising organic composition of capital. New Marxists and SSA theorists adopt an under-consumptionist position in which the economy becomes constrained by lack of demand owing to excessive wage squeeze. If the profit rate falls, it is due to Keynesian lack of demand which prevents the economy operating at an adequate level of activity. New Marxists and SSA theorists were previously separated by the new Marxist incorporation of financial factors, but SSA theorists have now accepted the importance of such factors.

Neo-Keynesians and old Keynesians, who dominated the economics profession until the late 1970s, dismissed problems of under-consumption and wage squeeze because of their belief in marginal productivity theory of income distribution. Instead, they located capitalism's problems in the volatility of investment spending due to unstable entrepreneurial animal spirits and fundamental uncertainty. They also believed that full employment could be maintained by activist monetary and fiscal policy.

Structural Keynesians retain the neo-Keynesian emphasis on the centrality of aggregate demand in determining the course of capitalist economies, but they reject the neo-Keynesian theory of income distribution and recognize the possibility of wage squeeze and under-consumptionist stagnation. That also means activist monetary and fiscal policy is not sufficient to ensure growth with full employment.

Putting the pieces together, orthodox Marxists are fundamentally divided from new Marxists and SSA theorists at the theoretical level. So too are neo-Keynesians and structural Keynesians. However, once financial forces are incorporated (including Minsky's financial instability hypothesis), new Marxists, SSA theorists, and structural Keynesians appear to share a broadly similar theoretical framework. If there is a difference, it may well be a difference of degree of optimism. Structural Keynesians believe it possible to design appropriate institutions that, combined with traditional Keynesian demand management, can escape capitalism's stagnationist tendencies and deliver full employment and shared prosperity. New Marxists and SSA theorists are more pessimistic about the capitalist process, the ability to escape stagnation, and the social possibilities of markets. Consequently, their institutional design would have a larger public sector and more nationalization, especially regarding the financial sector.

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