

# **From 2009 to 1929: lessons from Fisher, Keynes and Minsky**

## **Desmedt Ludovic**

Associate Professor, Université de Bourgogne  
LEG - UMR 5118 du CNRS  
Pôle d'économie et de gestion  
2, bd. Gabriel – BP 26611  
21066 Dijon cedex  
Tel: 03.80.39.54.38  
Fax: 03.80.39.54.43  
E-mail: ludovic.desmedt@u-bourgogne.fr

## **Piégay Pierre**

Associate Professor, Université de Bourgogne  
LEG - UMR 5118 du CNRS  
Pôle d'économie et de gestion  
2, bd. Gabriel – BP 26611  
21066 Dijon cedex  
Tel: 03.80.39.35.27  
Fax: 03.80.39.54.43  
E-mail: pierre.piegay@u-bourgogne.fr

## **Sinapi Christine**

Associate Professor, Ecole Supérieure de Commerce de Dijon  
Laboratoire du CEREN - ESC DIJON  
29, rue Sambin – 21000 Dijon  
Tel: 03.80.72.59.00  
Fax: 03.80.72.59.99  
E-mail: [christine.sinapi@escdijon.eu](mailto:christine.sinapi@escdijon.eu)

JEL classification numbers: E12, G01

## **Introduction**

Our economic system is currently in the throes of a major crisis and eighty years after the 1929 crash it is instructive to compare the two periods. First, the current crisis seems to be of a similar magnitude to that of the 1930s. Next, the mechanisms that led to the two episodes bear disturbing resemblances. And lastly, the measures currently contemplated to attenuate the repercussions of the crisis are reminiscent of certain policies implemented by Roosevelt in the US.

We attempt here to get some perspective on the current crisis and economic policy measures in the light of the 1929 crash.

The first part of the paper looks at the mechanisms that brought the crisis about. Excessive debt and over-optimism were both primordial in igniting the crisis. It will be very useful to an understanding of the current dynamics to revisit Minsky specifically on the degree of indebtedness of the financial structure.

The second part looks at crisis propagation mechanisms. Recurrent features notwithstanding, there is a marked difference between the 1929 crisis and the current one: it seems that in 1929 the stock-market crash spread to the banking system and the real economy whereas in the current crisis the credit system was hit before the stock exchanges.

To counter the current crisis, central banks have pumped liquidities into the economy and slashed their intervention rates. The various plans to stimulate the economy and automatic counter-cyclic mechanisms are making for ever greater government deficits. While such interventions are necessary, they do not seem able to ward off crises. In the final section, we show that they have obvious curative virtues but are less convincing when it comes to prevention.

# 1. The triggering factors: debt and speculation

Crises are supposedly characteristic primarily of monetary economies: “booms and depressions are phenomena peculiar to an economy in which (...) money is not neutral”.<sup>1</sup>

## 1.1. Common ground shared by Fisher, Keynes and Minsky

For Fisher, the cycle begins with an innovation that opens up new prospects for substantial profit. Such hoped-for profit is an incentive for investors to commit to this course of action and implies that they go into debt. That debt means that the early-birds make profits which fuel greed and optimism. That optimism brings in new investors and the overall debt level rises so long as the profits are there to be made.

This is where Keynes makes an essential contribution. It is well-known that Keynes identifies the reasons for this over-optimism in bullishness (strategic imitation).

Keynes’s starting point is that the economic environment is fundamentally uncertain: “by ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. (...) The sense in which I am using the term is that in which (...) there is no scientific basis on which to form any calculable probability whatever”.<sup>2</sup> And so he concludes that so far as the occurrence and scope of certain future events are concerned, all we can say is that “we simply do not know” (*ibid.*).

Keynes nonetheless lays the foundations for analysis of the decision-making process with his famous “animal spirits”: “our innate urge to activity which makes the wheels go

---

<sup>1</sup> Keynes (1933), p. 411.

<sup>2</sup> Keynes (1937), p. 113–114.

round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance”.<sup>3</sup>

In such a context, firms’ actions rely on subjective decisions that may prove less than reliable. It is understandable then that economic agents seek to improve their performance by turning to common opinion and by imitating others. The herd-like behaviour of investors sustains the upward movement. This escalates and may lead to over-optimism, bolstered by the realization of expected profits, which in turn are related to the rising asset prices generated by the purchases by growing numbers of agents. Optimism changes little by little into over-optimism at the same time as debt slides into excessive debt.

“The over-indebtedness (...) may be started by many causes, of which the most common appears to be new opportunities to invest at a big prospective profit, as compared with ordinary profits and interest, such as through new inventions, new industries, development of new resources, opening of new lands or new markets. Easy money is the great cause of over-borrowing”.<sup>4</sup>

Minsky also describes a dynamics that is endogenous to capitalist financial systems in which innovation and the profit seeking activity inexorably ignite a financial crisis and cumulative debt-deflation.

While the mechanisms of the financial crisis and its propagation are explicitly those of debt-deflation already expounded by Fisher, the mechanisms that trigger it are based on a more original analysis described in the “financial instability hypothesis” (FIH).<sup>5</sup> This hypothesis hinges on two “theorems”.

---

<sup>3</sup> Keynes (1936), p. 163.

<sup>4</sup> Fisher (1933), p. 348.

<sup>5</sup> Cf. Minsky (1986) and (1992b).

## 1.2. Financial instability

The first theorem defines the criteria of financial fragility from a well-known typology of balance-sheet analysis: hedge finance, speculative finance and Ponzi finance. The greater the “speculative” and “Ponzi” financial posture, the more fragile the economy and the greater the risk of crisis. This fragility reflects the balance sheet debt structure (financial commitments of firms, banks and households). Fragility arises not just from the liabilities structure, that is, from the proportion of debt instruments compared with equity liabilities, but also from the quality of assets, that is the capacity of the investments made to generate sufficient future cash flows to service the debt. The greater financial fragility results, then, from increased financial (debt) and operational (selection of risky investment projects) risk taking.

Two situations may be characteristic of “speculative” financing. The first relates to *a priori* speculative financing. The renewal of the debt results from the shortage of expected productive income to cover the initial cost of the debt. The risk is there from the time the agreement is signed. The second situation may be characterised as “potentially speculative”: what is *a priori* “hedge finance” may prove to be “speculative” *a posteriori*, if the financial commitment is sensitive by nature to market conditions.<sup>6</sup> The criteria of financial fragility are therefore based both on *ex ante* comparison of financial commitments to cash flows expected from the investment but also on the sensitivity of the financial package to market variations.

And so the greater the proportion of speculative and Ponzi positions, the more fragile the economy. This is the “first theorem” of Minsky’s instability hypothesis.

---

<sup>6</sup> Cf. Arestis and Glickman (2002).

The second theorem of the financial instability hypothesis "is that over protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance".<sup>7</sup>

The increased financial fragility is therefore an endogenous result generated within rising financial cycles. The driving forces behind this pro-cyclicality of risk-taking lie, for Minsky, in two types of factor:

- "the internal dynamics of capitalist economies" (*ibid.*);
- and "the system of interventions and regulations that are designed to keep the economy operating within reasonable bounds" (*ibid.*).

By the internal dynamics of capitalism, Minsky refers to what are for him the two key characteristics of financial economies: the profit motive and innovation. These two components act as incentives to risk-taking over extended periods of prosperity. The combination of innovation and inadequate regulation nurtures financial fragility.

Minsky seeks out the validity of the FIH in historical patterns. The benchmark remains the 1929 Great Depression, if only because it is the foundation stone of the works of Keynes and Fisher to which he refers. But the FIH has a more general vocation, which Minsky shows to be applicable in particular to the crises in the US in the 1980s.<sup>8</sup>

It might be thought that the sparking of the crisis is inexorably written in the self-sustained upswing preceding the reversal of the cycle. "A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals

---

<sup>7</sup> Minsky (1992b), p. 8.

<sup>8</sup> Cf. Minsky (1991) and (1992a).

is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady. (...) The market will be subject to waves of optimistic and pessimistic sentiment, which are unreasoning and yet in a sense legitimate where no solid basis exists for a reasonable calculation.”<sup>9</sup>

## **2. Propagation of the crisis: financial innovations and deflationary spiral**

In both periods it is the bursting of the bubble (the financial bubble in 1929 and the real-estate bubble in the late 2000s) that caused disaster. The popping of the speculative bubble fuels a debt-deflation type of crisis that spreads to the whole of the economy.

### **2.1. Financial innovations extend market access**

In the 1920s optimism related to innovation combined with the call loans system propelled the Dow Jones upward. However, this rise was part of a worrying general context. In *The Great Crash, 1929* Galbraith points out the shortcomings in US growth. In fact, while stock prices began to fall from 24 October, industrial activity had been contracting since June. In that context it is hardly surprising that the free-fall of the index had disastrous repercussions in many sectors. After the speculators and brokers, the first institutions to suffer from this sudden plunge in stock prices were the banks. It should be recalled that the United States case was very unusual: unlike banking sectors in most western countries at the time that were extremely concentrated, the US system was composed of a plethora of small local banks since numerous laws prohibited branch banking. By 1933 scarcely half of the banks listed in

---

<sup>9</sup> Keynes (1936), p. 154.

1929 were still in business.<sup>10</sup> That same year there were still 12.9% of bankruptcies in the sector. Accordingly, the real-estate sector suffered too: “the proportion of mortgaged owner-occupied houses with some interest or principal in default was in none of the twenty two cities [surveyed] less than 21 percent”.<sup>11</sup>

Recent events fit into a context of income inequality of a similar magnitude to that of the 1920s: “Income inequality in the US is at its highest since that most doom-laden of years: 1929. Throughout the main English-speaking economies, earnings disparities have reached extremes not seen since the age of *The Great Gatsby*”.<sup>12</sup> The great income inequalities of the 1920s meant that many US households were excluded from the real-estate market.<sup>13</sup> It was this impossibility that was removed in the 2000s by means of subprimes and securitization.

At the turn of the century, because of the increase in off-balance sheet operations (especially out of intent to circumvent prudential rules) and of the emergence of new actors, a shadow banking system surged to the fore.<sup>14</sup> With the boom in securitization, the divide between the credit-granting organization and the risk-bearers widened. Bond insurers (monolines) provided their security for structured products issued by investment banks.

Risk was then spread but remained within the financial system itself, and especially with the banks: banks bought up each others securities, financing those operations by borrowing (Banque de France, 2009). This directly made balance sheets in the financial system even more fragile. Moreover, the counterparty risk within the financial system was increased, because of the very operation of such over-the-counter contracts. Lastly, risk was

---

<sup>10</sup> Cf. Bernanke (1983).

<sup>11</sup> Hart, in Bernanke (1983), p. 260.

<sup>12</sup> Plender (2008).

<sup>13</sup> Bernanke (2007).

<sup>14</sup> Cf. Brender and Pisani (2009).

in part hidden because of the complexity of these structured products and the opacity of part of the institutions involved in the transfer operations (especially the hedge funds).

Securitization also concentrated risk. The top ten dealers on the CDS market handled more than 90 percent of transactions. The concentration ratio is even greater in the US where 97 percent of gross long-term trades are handled by the five biggest commercial banks (Banque de France, 2009). This risk of concentration is accompanied by a wrong-way risk related to the seller of protection itself being closely correlated with the reference entity of the claim. Instead of having redistributed the credit risk, securitization has concentrated it on a small number of extremely interdependent agents.

All told, Brender and Pisani (2009) claim that by mid 2007 the parallel banking system had attained at least the same size as the traditional banking system.

Paradoxically, the regulations devised to curb the risky character of certain practices led the system to propose an ever increasing supply of mortgage loans.<sup>15</sup> From the summer of 2007, defaults by subprime households multiplied and there was a rise in premiums in the various segments of structured credit, then doubt spread to claims as a whole. The closure of the two hedge funds managed by Bear Stern in June 2007 inaugurated the rude awakening.

So even if both periods are marked by banking, stock-market and real-estate crises, the sequence orders are different: recent events began in real-estate and banking whereas in 1929 the crisis was initially on the stock-exchange and then propagated to the banking system and the real economy.

---

<sup>15</sup> Cf. Orléan (2009), p. 17.

	<b>US 1929–1933</b>	<b>US 2007–...</b>
<b>CONTEXT</b>	Marked income inequality; rise in Dow Jones prompted by call loans	Marked income inequality; speculative boom in real-estate market (subprime credits, securitization)
<b>SEQUENCE OF EVENTS</b>	<b>A -&gt; B -&gt; C</b>	<b>C -&gt; B -&gt; A</b>
Stock- exchange crisis  (A)	The Dow Jones index stops rising on 3 October and the crash comes on 24 October 1929. The call loan system spells trouble for brokers and bankers	Securitization contaminates the balance sheets of financial institutions and spreads illiquidity. Downturn in stock-market capitalization on the leading exchanges
Banking crisis  (B)	The many small banks are exposed to bank runs; almost half of the banks close between 1929 and 1933	Proliferation of intermediaries and creation of a barely regulated shadow banking system; increasing numbers of defaults hits this parallel system and investment banks
Real-estate crisis  (C)	As a result of bankruptcies and high unemployment, difficulties in the real-estate sector (especially in rural housing)	Turnaround in the real-estate market after an uninterrupted price rise from 1997 to 2007

See also Boyer (2009)

## 2.2. Bubbles and cumulative processes

In the boom period, agents in a bull market do not notice the transition from debt to excessive debt or from optimism to euphoria. “A boom is a situation in which over-optimism triumphs over a rate of interest which, in a cooler light, would be seen to be excessive”.<sup>16</sup> Asset prices have risen too far compared with the prospects for profit, but it is precisely the ongoing boom that prevents collapse. However, the movement must end at some point. “The disillusion comes because doubts suddenly arise concerning the reliability of the prospective yield. (...) Once doubt begins it spreads rapidly”.<sup>17</sup> The excesses that precede the crash are also its cause. According to Keynes, “when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic force”.<sup>18</sup>

Fisher clearly identifies the consequences of the bubble bursting. The need to escape debt implies liquidating positions. The trend reverses suddenly and there is a collective movement to sell. This movement obviously causes asset prices to fall. If asset values fall, the guarantees that they represent fall in value by a corresponding amount, and the weight of debt in balance sheets increases.

Business in need of liquidity accept to lower their selling prices. Profit margins shrink and businesses cut production. Unemployment rises and wealth contracts. To cope with this reduced demand as a result of higher unemployment, firms continue to cut their prices. The fall in asset prices is sustained by catastrophe selling. As Boyer put it so well, a perverse dialectic sets in between the search for liquidity and deflation.<sup>19</sup>

---

<sup>16</sup> Keynes (1936), p. 322.

<sup>17</sup> *Idem*, p. 317.

<sup>18</sup> *Idem*, p. 316.

<sup>19</sup> Boyer (1988), p. 189.

It is the attempt to get out of debt that is the source of deflation, which itself is at the source of the escalation of the real debt. Efforts to reduce debt end up increasing it: “deflation caused by the debt reacts on the debt. (...) If the over-indebtedness with which we started was great enough, the liquidation of debts cannot keep up with the fall of prices which it causes. In that case, the liquidation defeats itself. (...) Then, *the very effort of individuals to lessen their burden of debts increases it, (...) the more the debtors pay, the more they owe*”.<sup>20</sup>

While the nominal debt falls, the debt-to-GDP ratio rises because of the marked downturn in activity. Besides, the fall in the nominal debt is more than offset by the fall in prices with the consequent rise in the burden of debt in real terms. The resemblance with the changes in the US real-estate market in the current crisis is striking.

The original feature about Minsky’s proposal probably lies in the endogenous character of the turn-around.

First of all, the rise in interest rates is at the origin of the turn-around of the cycle and the triggering of the crisis. In a context of great financial fragility, a rise in interest rates pushes Ponzi and “speculative” entities to default. The profits of “speculative” firms being just enough to cover interest payments, an increase in interest combined with the need to constantly roll over their debt changes them into “Ponzi” businesses. Now, to survive, Ponzi businesses have to increase their debt in each period. Their equity is rapidly drained and they go bankrupt.

In addition, firms’ balance sheets are interrelated: default by the borrower has a knock-on effect on the lender who, deprived of the flow of liquidities it was counting on, is compelled to fire-sell assets to honour its own commitments. This leads to a collapse of the value of assets and further weakens the balance sheets.

---

<sup>20</sup> Fisher (1933), p. 344.

Under the financial instability hypothesis, higher interest rates also drive asset prices down and impel the recession. Minsky describes a novel investment dynamic based on a “two-prices” system. By this approach, two types of price co-exist: the price of capital assets and the price of current output. The first is equal to the discounted value of profits expected from the asset in question. The second is equal to the production costs of the asset. Investment is determined by the difference in prices of capital assets and current output. Minsky resumes this conclusion: “When the price level of capital assets is high relative to the price level of current output, conditions are favourable for investment; when the price level of capital assets is low relative to the price level of current output, then conditions are not favourable for investment, and a recession—or a depression—is indicated”.<sup>21</sup>

In parallel, the increasing debt of businesses increases the risk of borrowers and lenders: “the borrower’s risk will increase as the weight of external or liquidity diminishing financing increases”.<sup>22</sup> Now, the increased risk for the borrower is reflected by a higher risk perceived by the lender and by an endogenous rise in the interest rate. This phenomenon is further reinforced by the increased lender risk, that reflects the bank’s perception. It also results from “peer” supervision by other banks in the context of interbank financing. The rise in the bank’s borrowing rate is passed on to its lending rate.

The rise in interest rates is reflected by an increase in the discount rate and so a fall in the capital assets price. For an unchanged production cost, investment falls, making for further financial fragility.

For Minsky, the financial fragility of an economy rises mechanically in periods of extended prosperity, leading to a rise in interest rates that ignites the crisis. The sequence of events seems inescapable: an upward cycle, increased financial fragility, rising interest rates,

---

<sup>21</sup> Minsky (1986), p. 143.

<sup>22</sup> Minsky (1986), p. 191, in Nasica (1997), p. 869.

falling capital asset prices, a cumulative debt-deflation crisis. Financial instability results from an endogenous internal dynamic that forms Minsky's financial instability theory.

The emergence and development of subprime credits, of securitization of counterparty risk and of instruments such as CDOs and CDSs combined with insufficient regulation of these structured products and of financial intermediaries contributed to the development of a new kind of financial fragility. Comparison of the patterns of the average leverage of primary dealers in the US and financial cycles is striking. The peaks of leverage systematically coincide with the periods preceding the latest crashes (1988, 2000, 2008). The increased debt and greater risk associated with the development of subprime credits also illustrates this increased financial fragility until 2007.

Moreover, securitization and the associated structured products consist in passing on the counterparty risk inherent in initial credit activities to other agents. They make it possible therefore *a priori* to relieve banks of some of their counterparty risk by supplying them with cover and to transfer that risk to another reference entity capable of handling it. However, in practice, such structured contracts have:

- given considerably greater leverage to financial institutions,
- reinforced the interdependence of balance sheets within the financial system,
- and powered margin-call mechanisms of the debt-deflation type.

Apart from the actual scenario of the current crises that seem to reflect the forecasts of the financial instability hypothesis, the development of securitization seems to have initiated a new form of financial fragility.

### **3. Out of the crisis: What measures to take and what avenues to explore to avoid new catastrophes?**

#### **3.1. Support for activity after the crash**

If the end of the thirty years of post-war prosperity “saw Keynes die a second time”, we are certainly now witnessing some kind of resurrection of his recommendations. The measures currently being taken by various states are clearly of Keynesian inspiration. As Fisher asserted in his 1933 paper on Roosevelt’s measures to get the economy moving: “those who imagine that Roosevelt’s avowed reflation is not the cause of our recovery but that we had ‘reached the bottom anyway’ are very much mistaken”.<sup>23</sup>

Fisher justified the “reflation” on several occasions and regretted that monetary policy was not implemented more widely and for longer after the 1929 stock-market crash.

After 1929 the Federal Reserve Bank did not feel its mission was to save failing banks. The contraction of credit was not engendered solely by a hyper-restrictive Fed policy. Demand for credit had undoubtedly collapsed: the downturn in industrial orders, the difficulties of the farming and real-estate sectors provided no incentive for agents to borrow. For example, automobile purchases fell by two-thirds between 1930 and 1933. As Governor Harrison who succeeded Benjamin Strong at the head of the New York Bank said: “If you give [the banks] *too much* excess reserves *when they lack confidence* it is *just like flooding the carburetor of an automobile*”.<sup>24</sup>

By contrast, in the summer of 2007, when the size of the crisis was appraised, the Fed launched some extremely generous bailout operations.<sup>25</sup> This did not prevent a downturn on

---

<sup>23</sup> Fisher (1933), p. 346.

<sup>24</sup> Quoted by Mayhew (1983), p. 358.

<sup>25</sup> Cf. Lordon (2008), p. 131.

the major financial markets that was to lead to stock market capitalization being halved between early 2008 and early 2009.

If we are not in a cumulative debt-deflation phase today, it is because Keynesian policies were implemented forcefully and swiftly and because counter-cyclic mechanisms played their part. Rescuing the financial sector as a whole has obviously been paramount. Massive inputs of liquidities and the marked lowering of central bank interest rates played a crucial role in checking the deflationary spiral from the time the cycle turned around. The same is true of the various schemes implemented by different governments to stimulate the economy. For Fisher, in such a situation, “it would be as silly and immoral to ‘let nature take her course’ as for a physician to neglect a case of pneumonia”.<sup>26</sup>

Minsky also defended public intervention to stem the crisis. He summarized his proposals as (i) the creation of a *Big Bank* intervening both as lender of last resort and providing a form of prudential supervision of the financial and banking system and (ii) the setting up *Big Government*, implying the use of the public deficit to revitalize the economy after the crisis.

However, while the implementation and the beneficial results of these actions are not really controversial, some questions remain unanswered.

### **3.2. The dilemma of monetary activism and the dilemma of liquidity**

When there are such fast and furious rises as those that preceded the 1929, 2000 and 2007 crises, everyone knows that a bubble is swelling. Everyone knows too just as well that

---

<sup>26</sup> Fisher (1933), 347.

"no tree grows to heaven".<sup>27</sup> For the bull trend to continue, a mechanism of the type exposted by Galbraith in *A Short History of Financial Euphoria* is required to sustain it.<sup>28</sup> One must in a sense persuade opinion that what is happening is normal, contrary to what one might intuitively think. One must portray as normal and desirable a phenomenon that plainly is not, even if it means stigmatizing the more sceptical commentators.

It is then that recurrent talk of the "new economy" arises.<sup>29</sup> Besides, if the boom is initiated by innovation and prospects of high profits, there seems to be a "real" basis on which to justify the escalating debts and asset prices (whether financial in 1929 or 2000, or real-estate in 2007).

However, Fisher reminds us that "there is probably always a very real basis for the 'new era' psychology before it runs away with its victims. This was certainly the case before 1929".<sup>30</sup> This was also certainly the case before 2000 and 2007...

### *The dilemma of monetary activism*

If we compare the shifts in central bank interest rates and those of the main stock market indexes, it seems that the unfolding of the events of the 2000 and 2007 crises are disturbingly similar.

While Keynes advocates implementing an expansionist monetary policy once the high point has been reached, he posits the foundations of the dilemma: "an increase in the rate of

---

<sup>27</sup> According to Keynes, this "does not even require gulls amongst the public to feed the maws of the professional" (1936, p. 155). In fact, agents happily take part in the game while perfectly aware there will necessarily be a loser (*ibid.*).

<sup>28</sup> Cf. Galbraith (1993).

<sup>29</sup> Bradford de Long (1999) warns us against such "forecasts" about the end of cycles that seem to be recurrent when an economy enjoys a long period of substantial growth.

<sup>30</sup> Fisher (1933), p. 349.

interest, as a remedy for the state of affairs arising out of a prolonged period of abnormally heavy new investment, belongs to the species of remedy which cures the disease by killing the patient”.<sup>31</sup> It seems we are faced with a dilemma. A Greenspan dilemma as it were: the role of the central bank is not to halt growth but to intervene once the crisis has been ignited.

When in the midst of the doldrums, the fall in interest rates is probably not sufficient because at this point in the cycle “it is not so easy to revive the marginal efficiency of capital, determined, as it is, by the uncontrollable and disobedient psychology of the business world. It is the return of confidence, to speak in ordinary language, which is so insusceptible to control in an economy of individualistic capitalism”.<sup>32</sup> Intervention is indeed required, then, but *after* the crash: “Later on, a decline in the rate of interest will be a great aid to recovery and, probably, a necessary condition of it”.<sup>33</sup>

Several points should be emphasized.

It is not obvious that keeping interest rates down during the exaggeratedly buoyant phase can prevent the crash. It might even encourage the boom. If the fall is that much harder after a strong surge, one might wonder about the need for such a policy. Moreover, if one follows the FIH logic, the rise in interest rates that caused the turn-around in the cycle is itself endogenous. In the 2000 and 2007 crises, it can be seen that the interest rate rise accompanied and precipitated the change in share prices.

If one accepts the turn-around as inevitable, the question of up-stream regulation must be asked. The bursting of the bubble is costly for the collectivity because of the severe real adjustments in terms of capital and labour. If the beginning of the bust can be seen in the

---

<sup>31</sup> Keynes (1936), p. 323. Greenspan takes up this argument from Keynes: “the remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom” (*idem*, p. 319).

<sup>32</sup> *Idem*, p. 317.

<sup>33</sup> *Idem*, p. 316.

boom, an attempt should be made to forestall it at this point. Otherwise, and to continue with the medical metaphor so dear to Fisher, it would be as if a physician diagnosed an initially benign illness, knew perfectly well what caused it and the chances it would degenerate into a much more serious illness, and yet did nothing until it broke out and its symptoms were quite apparent.

Low interest rates were probably one of the reasons for the internet bubble swelling and bursting. Lowering them markedly in the context of a deliberate economic policy after the crash was certainly one of the causes of the current crisis (swelling of the real-estate bubble).

The question to be asked is whether the current movement of interest rates heralds a new cycle and a new crisis? The dilemma lies in the fact that such lowering is a necessary condition to combat the current crisis. Nonetheless, if it were to contain the seeds of the next crisis, there would be cause for concern in that, unless one were fatalistic. It is as though the necessary monetary activism of after the turn-around were the breeding ground for future crises.

### *The liquidity dilemma*

The foregoing arguments obviously do not dismiss the need for a liquid and effective financial market. Nonetheless, what Keynes calls the liquidity dilemma is still with us: “the liquidity of investment markets often facilitates, though it sometimes impedes, the course of new investment. For the fact that each individual investor flatters himself that his commitment is ‘liquid’ (though this cannot be true for all investors collectively) calms his nerves and makes him much more willing to run a risk”.<sup>34</sup>

---

<sup>34</sup> Keynes (1936), p. 160.

We seem sometimes to conflate the need for liquidity and the nuisance of excess speculation. For example, what is the social interest in making real-estate investments liquid by securitization if not to let the bubble swell? While the various financial actors in the sector were severely hit as a result of the crash in the real-estate sector, the real adjustments in terms of capital and labour have also had dramatic consequences across the board.

In this respect Orléan notes that securitization is “the decisive stage in the process designed to promote financial liquidity”,<sup>35</sup> and Bernanke observes that this change was a major one: “The shift from reliance on specialized portfolio lenders financed by deposits to a greater use of capital markets represented the second great sea change in mortgage finance, equaled in importance only by the events of the New Deal”.<sup>36</sup>

Preventing certain financial practices or innovations from becoming dangerous and harmful for the collectivity as a whole is a legitimate aim that does not call into question the need for effective financing of economic activity. Indeed, according to Keynes, “speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done”.<sup>37</sup> This implies being watchful that this remains the normal situation. Keynes considers that “the proper social purpose [of stock exchanges] is to direct new investment into the most profitable channels in terms of future yield”.<sup>38</sup> It is a matter of finding the right balance between the speculation required for liquid investment and excess speculation that inexorably leads the system into crisis: “Of the maxims of orthodox finance none, surely, is more anti-

---

<sup>35</sup> Orléan (2009), p. 53.

<sup>36</sup> Bernanke (2007).

<sup>37</sup> Keynes (1936), p. 159.

<sup>38</sup> *Idem*.

social than the fetish of liquidity. [...] The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future”.<sup>39</sup>

Keynes sometimes points to ways of doing this whether by limiting the power of financial agents—“it is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of stock exchanges”<sup>40</sup>—or by introducing a tax on speculation—“the introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States”.<sup>41</sup>

Minsky also enunciates a series of measures, including the overseeing of all financial institutions by the Big Bank and the control of incentives in the financial system by public institutions. Unlike in 1933 and in the 1980s, such measures are in place nowadays. They are at the heart of debates on the current reform of financial regulation. Thus, the more widely-supported measures reflect these ideas: control of bonuses and revision of the equity ratios, or control of all agents and instruments. Minsky’s proposals seem to have been heard, so much so that the Governor of the *Banque de France*, C. Noyer, concluded his preface to the latest review of financial stability on regulatory reform by citing Minsky.

What Minsky already saw as being the most difficult thing remains to be done: to implement such actions technically and with genuine political will. On this point, despite the statements of intent, there is room for doubt. The emergence of new forms of securitization in 2009 (securitization of life assurance and REMICs – securitization of conduits on already

---

<sup>39</sup> *Idem*, p. 155.

<sup>40</sup> *Idem*, p. 159.

<sup>41</sup> Keynes (1936), p. 160.

securitized mortgages<sup>42</sup>) do not seem to indicate that we are going down that road, at least in the short term.

Ultimately, the endogenous dynamic Minsky examines leads him to pessimistic conclusions: “Such a restructuring will enjoy only transitory success. After an interval, the basic disequilibrating tendencies of capitalist finance will once again push the financial structure to the brink of fragility. When that occurs, a new era of reform will be needed”.<sup>43</sup>

## Conclusion

What perspectives can we draw from this analysis of the current crisis as illuminated by this Fisher–Keynes–Minsky lineage? The analyses of our three economists provide a coherent overall explanation of this type of crisis. They lead us in particular to look at the dilemma of interventionism and the dilemma of liquidity and they highlight the risks of credit granting processes going into overdrive.

One might ask whether the return to grace of Keynesian precepts is a passing phase and related to economic circumstance or whether it is a much deeper movement. The relative coordination of recovery schemes has prevented paralysis of the system, but it is the long-term reform measures that will provide a clear answer to this question. If far-reaching regulatory measures consisting in making lenders more responsible and increasing supervision are taken, then, as in the 1930s, those who think the financial system should be more closely controlled will have been heard. If these are simply sporadic measures consisting in decrying certain actors of the system, it is to be feared that such temporary measures will not prevent—in the more or less short term—the occurrence of other crises.

---

<sup>42</sup> Morgan Stanley raised \$30 billion on residential REMICs in late September 2009.

<sup>43</sup> Minsky (1986), p. 370.

An attempt to solve the dilemmas mentioned requires bringing politics back to centre stage, for it is a matter of developing sweeping new measures for regulating sophisticated financial systems. Consideration of the collective impact of such measures is fundamental, in view of the harmful socio-economic consequences of such catastrophes. It is highly likely that the actors in the financial systems do not have the capacity to do this. We should be mindful of what Keynes wrote on this point in August 1931: "Like the honest citizens they are, [bankers] feel a proper indignation at the perils of the wicked world in which they live - when the perils mature; but they do not foresee them. (...) if they are saved, it will be, I expect, in their own despite".<sup>44</sup>

## References

- ARESTIS P. and GLICKMAN M. [2002], "Financial Crisis in South-East Asia: Dispelling the Illusion the Minskyan Way", *Cambridge Journal of Economics*, Vol. 26, n° 2, p. 237-260.
- BANQUE DE FRANCE [2009], "Quel avenir pour la régulation financière ?", *Revue de Stabilité Financière*, sept.
- BERNANKE B. [1983], "Non-monetary Effects of the Financial Crisis in the Propagation of the Great Depression", *The American Economic Review*, Vol. 73, n° 3, p. 257-276.
- BERNANKE B. [2007], "Housing, Housing Finance, and Monetary Policy", *Federal Reserve Bank of Kansas City's Economic Symposium*, Jackson Hole, Wyoming, August 31.

---

<sup>44</sup> Keynes (1931), p. 158.

- BOYER R. [1988], "D'un krach boursier à l'autre : Irving Fisher revisité", *Revue française d'économie*, vol. 3, n° 3, p. 183-216.
- BOYER R. [2009], "Feu le régime d'accumulation tiré par la finance", *Revue de la régulation*, vol. 5, first semester.
- BRADFORD de LONG J. [1999], "Introduction to the Symposium on Business Cycles", *Journal of Economic Perspectives*, vol. 13, n° 2, p. 19-22.
- BRENDER A. and PISANI F. [2009], *La crise de la finance globalisée*, Repères, La découverte, Paris.
- FISHER I. [1933], "The debt-deflation theory of great depressions", *Econometrica*, vol. 1, n° 4, p. 337-357.
- GALBRAITH J.K. [1955], *The Great crash, 1929*, Hamish Hamilton, London.
- GALBRAITH J.K. [1993], *A Short History of Financial Euphoria*, Penguin Books, London.
- KEYNES J.M. [1931], "The Consequences to the Banks of the Collapse of Money Values (August 1931)", *Essays in Persuasion*, in *The Collected Writings of John Maynard Keynes*, vol. IX, Macmillan, Cambridge, p. 150-158.
- KEYNES J.M. [1933], "Festschrift für Arthur Spiethoff (1933): 'a monetary theory of production'", in *The Collected Writings of John Maynard Keynes*, vol. XIII, Macmillan, Cambridge, p. 408-411.
- KEYNES J.M. [1936], *The General Theory of Employment, Interest and Money*, *The Collected Writings of John Maynard Keynes*, vol. VII, Macmillan, Cambridge.

- KEYNES J.M. [1937], "The general theory of employment", in *The Collected Writings of John Maynard Keynes*, vol. XIV, Macmillan, Cambridge, p. 109-123.
- LORDON F. [2008], *Jusqu'à quand ? Pour en finir avec les crises financières*, Raisons d'agir, Paris.
- MAYHEW A. [1983], "Ideology and the Great Depression: Monetary History Rewritten", *Journal of Economic Issues*, vol. XVII, n° 2, p. 353-360.
- MINSKY H.P. [1986], *Stabilizing the Unstable Economy*, Yale University Press, New Haven.
- MINSKY H.P. [1991], "Financial Crises: Systemic or Idiosyncratic", *The Levy Economics Institute Working Paper Collection*, n° WP51.
- MINSKY H.P. [1992a], "The Capital Development of the Economy and the Structure of Financial Institutions", *The Levy Economics Institute Working Paper Collection*, n° WP72.
- MINSKY H.P. [1992b], "The Financial Instability Hypothesis", *The Levy Economics Institute Working Paper Collection*, n° WP74.
- NASICA E. [1997], "Comportements bancaires et fluctuations économiques : l'apport fondamental d'H.P. Minsky à la théorie des cycles endogènes et financiers", *Revue d'économie politique*, n° 107, nov.-déc., p. 853-873.
- ORLEAN A. [2009], *De l'euphorie à la panique : penser la crise*, Eds ENS rue d'Ulm, Paris.
- PLENDER J. [2008], "Mind the gap", *Financial Times*, April 7.