City Research Online

City St George's, University of London

Citation: Nesvetailova, A. (2008). Ponzi Finance and Global Liquidity Meltdown: Lessons from Minsky (CUTP/002). London, UK: Department of International Politics, City University London, ISSN 2052-1898.

This is the unspecified version of the paper.

This version of the publication may differ from the final published version. To cite this item please consult the publisher's version.

Permanent repository link: https://openaccess.city.ac.uk/id/eprint/1286/

Copyright and Reuse: Copyright and Moral Rights remain with the author(s) and/or copyright holders. Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge, unless otherwise indicated, provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way. For full details of reuse please refer to City Research Online policy.

City Research Online: http://openaccess.city.ac.uk/ publications@citystgeorges.ac.uk

City University London
Centre for International Politics

WORKING PAPERS ON
TRANSNATIONAL POLITICS

PONZI FINANCE AND GLOBAL LIQUIDITY MELTDOWN: LESSONS FROM MINSKY

Anastasia Nesvetailova

Working Paper CUTP/002
© Anastasia Nesvetailova, February 2008
This is a work in progress. Feedback welcome.
Contact: a.nesvetailova@city.ac.uk

Series Editor: Tom Davies (tom.davies@city.ac.uk)

Introduction

As the meltdown sparked by the sub-prime mortgage fiasco in the USA continues to shake the world markets, the name of one of the twentieth century greatest critics of a deregulated finance, Hyman Minsky (1919-1996) is suddenly on everyone's lips. Observers, whether on the left or on the right, argue that we are experiencing the collapse of 'Minskyan' Ponzi-type financial pyramids. We certainly are. But what does this mean? And what precisely does a 'Minskyan' reading of finance suggest about the current state of the world financial markets? This paper shows that a Minskyan lens of analysing financial fragility brings out two critical, and intertwined, elements of the ongoing crisis: a Ponzi-type mode of pyramid financing; and a highly controversial, even deceptive, notion of liquidity. The complex inter-play between a Ponzi-type financial structures operating at the global level, and regulators' inability to diagnose the liquidity situation accurately, cast doubt on whether, and to what effect, will policy measures aimed to deal with the current crisis, work.

Hyman Minsky and the global credit crunch

Hyman Minsky, an American economist of Russian descent, developed his theory of financial instability in the 1960s and 1970s. For a long while, Minsky's post-Keynesian vision made him an outsider of mainstream finance theory. Only recently his analysis found resonance with mainstream economics. What is particularly worrying and unique about the financial system, Minsky famously argued, is that stability is paradoxically destabilising: 'good times' encourage experimentation and excessive risk-taking, ending up with a bang. This vision is particularly worrying for two reasons. First, it suggests that left to its own, the financial system is inherently unstable. Second, and that something that economists seem to have difficulties accepting, instability does not conform to a single model. The precise nature and outcome of the collapse depends on the specific characteristics of the economy in question. Since historical, political, social and institutional settings of capitalism vary greatly, it is difficult to predict the precise moment a financial crisis erupts. At the same time, Minsky argued

that fundamentally, instability and fragility stem from the unstoppable process of financial innovation.[1]

This insight into the nature of financial innovation makes Minsky's theory pertinent to today's world. At a time when regulators are baffled by the size of intricately packaged debts crumbling big corporations, it is clear that the state of the global credit system is primarily defined not by formal legislation and regulation, but by the continuing process of innovation of new financial products, practices and institutions. This heady 'cocktail of innovation' makes the task of public monitoring and control of the financial system incredibly difficult, if not outright impossible. There are at least two reasons for this. The first has to do with the very nature of financial innovation: typically, newly devised financial techniques and products add to a sense of optimism and confidence in the strength of the markets. Up until the summer of 2007, many policymakers and regulators continued to praise what they perceived as the wider risk-management facilities offered by new derivative products and in particular, the process of securitisation. Only quite recently, one official boldly declared: "a number of changes in the environment [that] point to some sustainable reduction in risk premia: more credible monetary regimes, more flexible labour and product markets…; improved instruments and markets for managing risk; better diversified portfolios."[2] A few months later, as the world markets continue to crumble and more and more big financial houses write off billions of dollars, the hidden side of this new financial environment comes into light. Optimism offered by new techniques is deceptive. While for a short while new products and techniques may help diversify companies' portfolio and add to a sense of robustness and liquidity in the markets, in fact many of these so-called new products only re-distribute, and worse, hide and multiply the risks involved. Indeed, the latest 'hot' product of the global spiral of financial evolution

[1] Minsky, H., 1982a, *Can 'It happen Again?,* New York: M.E. Sharpe. Minsky, H. 1982b, "The Financial Instability Hypothesis: Capitalist Processes and the Behavior of the Economy ", in Ch. Kindleberger and JP. Laffargue, *Financial Crises. Theory, History and Policy,* Cambridge: Cambridge University Press.Minsky, H., 1986, *Stabilizing an Unstable Economy*, New Haven, Conn.: Yale University Press. Minsky, H., 1991, "Financial Crises: Systemic or Idiosyncratic", *Working Paper No. 51,* Jerome Levy Economics Institute, Bard College, April.

[2] Lower risk premia – compressed risk premia, coupled with high appetite for risk. All in Tucker, P., 2007, " A Perspective on recent monetary and financial system developments", speech to Merrill Lynch Conference, 26 April, page 5.

- collateralised debt obligations (CDOs) - turned out to be the pinnacles of the ongoing credit crunch.

The second reason for the confusion among policymakers and regulators dealing with the credit crunch has to do with their own policies. Financial deregulation and liberalisation, so highly praised a decade ago, turned out to be a dangerous beast, and has gone out of hand of public authorities. According to the data from the BIS, by June 2007, about 84% of all trades in financial derivatives take place in Over the Counter (OTC) markets, not on regulated exchanges.[3] Unlike an organised stock exchange, in OTC markets, trading takes place on a one-to-one basis between the buyer and the seller, and prices and volumes of trades are not disclosed.[4] Effectively, that means that the market is unregulated and uncontrolled. Nearly half of global lending is siphoned off through offshore financial centres, and due to the lack of transparency of these centres, we simply do not know when highly complex financial pyramids reach critical proportions. We do not know who exactly owes what and to whom in the offshore world. Moreover, while the process of securitisation has made many assets highly tradable, the 'bundling together' of such assets makes the task of evaluation price exposures, the nature of risks involved, as well as the very identity of borrower and lender, virtually impossible. In the global privatised credit system, as markets begin to sense speculation has gone over the top, nervousness spreads, triggering a crisis. Which is what is happening in the credit crunch of 2007-2008. And which is why the name of Minsky, who for a long while had been on the margins of mainstream finance and economics, suddenly recurs on the pages of the *Financial Times,* the *Economist* and even the IMF.

In itself, this is surprising. Hyman Minsky was a pessimist: his vision of financial capitalism emphasises inherent instability, and unpredictability, of finance, rather than optimality of free markets. And although some observers of the current meltdown believe that much like many previous episodes of instability, this is only a temporary, and benign, correction of markets values,

[3] BIS. Derivatives Statistics; Quarterly, Basle: Bank for International Settlements.
[4] Dodd, R., 2007, "Subprime: Tentacles of a crisis*", Finance and Development*, December, 44:4.

there are many reasons why Minsky's pessimistic interpretation of events may offer a more accurate, and sobering, reading of the crisis and its implications.

The Ponzi constitution of today's financial system

The most oft-cited element of Minsky's model is the distinction he introduced between three modes of finance: hedged, speculative and Ponzi. An advanced financial system goes, he says, through three stages: it begins with hedged finance, whereby borrowers raise money against collateralised assets. But as the period of growth continues, borrowers over-estimate the potential for growth, and borrow against future asset growth: in short, they speculate. Eventually, the bubble of speculative finance develops into what Minsky called Ponzi finance. The term comes from Carlo Ponzi, the most famous, though clearly not the only one, architect of a pyramid scheme. Ponzi's pyramids, involving 'investment' in real estate and land, ripped off more than forty million Americans during the US property boom of the 1920s. He was convicted of fraud several times, and died in poverty. Minsky's usage of the term Ponzi describes a financial unit that can only service past debts by new borrowings, and thus is de facto bankrupt – it is the inter-bank equivalent of paying your Visa card by borrowing on your Mastercard.

Essentially, a Ponzi collapse is a debt crisis: when there is too much debt accumulated by an economic agent, and there is no way to either get the resources to pay the debt (and interest), postpone the payments, or shift the debt on to someone else, economic agents face insolvency. Plain and simple. The political and economic underpinnings of Ponzi finance in the sub-prime market are very complex. According to Jan Kregel of the Levy Institute, they are critically related to the way risk has been valued, assessed, and modelled, by banks and financial institutions since the liberalisation reforms were introduced in the 1980s. In this element, he notes, the ongoing financial crisis does differ from the context Minsky identified originally, yet the consequences will be severe: it may still lead to a process of debt deflation and recession.[5] The fact that a subprime crisis in the USA (which was entirely unavoidable, considering that rising interest rates were bound to hit those who had difficulties paying

[5] Kregel, J., 2007, " Minsky's cushions of safety. Systemic Risk and the Crisis in the US Subprime Mortgage Market", Policy Brief, Levy Economics Institute of Bard College.

even during the good times) is generating systemic nervousness around the world, suggests that we are in the midst of a structural collapse of Ponzi schemes.

Yet apart from the seer scale of the collapse and uncertainty as to its long-term consequences, there is another crucial, yet so far overlooked, aspect of the current crisis. Ponzi finance, as the label suggests, implies a crucial role of intentional deceit: financing debts with new borrowings is the basic principle of a pure pyramid scheme. In the 1990s post-socialist Europe for instance, many people repeated Carlo Ponzi's fate, and have been imprisoned for fraud through the construction of financial pyramids. The current crisis in the world markets, therefore, raises some uneasy political questions: What was the role of fraud, corruption and simple negligence in the recent expansion of the mortgage bubble, the hedge fund industry and other opaque segments of global finance? Would it be correct to suggest that European and other international markets, which today are all feeling the strains of the US subprime malaise, have themselves become embroiled, wittingly or unwittingly, in Ponzi schemes?

In this instance, the tale of Northern Rock is revealing. The scandal of the British bank shows not only how dangerously interconnected financial markets have become, although this seems to be the lesson most commentaries chose to draw from the Rock's collapse. Much more worryingly, the collapse of the bank revealed that the political regime of deregulated credit and the economic climate requiring companies to come up with ever more sophisticated ways to originate, value, manage and trade risk, actually helps disguise, if not encourage, fraudulent financial practices. Worse, existing regulation of financial innovation may help 'clever' financers make their frauds seem legitimate.

Two – very problematic - elements behind the Rock's story are relevant in this case. The first is what seems to be pure financial negligence and unaccountability: the management of the Bank has failed to act on the rising riskiness and correspondingly, progressive deterioration of the quality of loans offered to its customers. According to the *Guardian's* investigation of the Rock's portfolio, in the short period of three years, mortgage loans of over 90% of the purchase price of a house have soared eightfold (from £2.7 bn to £16bn). On nearly 2,500 mortgages, loans have exceeded the value of the property, with a

value of £263m (Three years ago, the figure was £13m on 158 homes). Arrears in repayments to the Rock, in turn, have been growing: around 10,000 Rock customers were a month or longer late in their mortgage repayments, on loans worth nearly £1.2bn. (At the end of 2003, there were only 2,500 in the same difficulties, with mortgages worth £168.8m.). Moreover, if in 2003 the Rock repossessed 80 properties, in 2006 the figure rose to more than 1,000 properties. By the end of September 2007, according to the *Guardian,* 912 properties had been repossessed.[6] Why was this apparent deterioration of the bank's portfolio not acted upon in time, and why did the bank continue to lend and trade in complex financial products knowing that the risks on already outstanding loans are growing?

One possible answer to these questions suggests simple negligence on the part of the Bank's managers. That scenario implies that the crisis of Northern Rock is a one-off phenomenon, and does not require any systemic action. Another possible answer is more sobering: in the global credit boom, the bank got carried away, probably further encouraged by the notorious moral hazard factor: it is too important to be allowed to fail. (Which is why billions of pounds of public money will now be used to bail the bank out). Considering that the Rock was not alone in the game of sub-prime mortgage and securitised finance, the latter answer seems to be more realistic. As Jan Kregel's explains, in the contemporary financial system, companies manage risk on the basis of 'originate and distribute' principle: banks seek to maximize their profits by moving lending to unrelated affiliates, and off their balance sheets.[7] That implies that seeds of a Minskyan Ponzi crisis stem not from individual undervaluation of risks by financial companies (as simple negligence by Rock's managers would imply), but from the very constitution of the modern credit system itself. This reading of the Rock's crisis, and the credit crunch as a whole, would require a much more radical, and comprehensive, political response. Individual bailout and even temporary nationalisation will not suffice to restore stability, at least not in the long run.

[6] Griffiths, I., 2007, "Revealed: massive hole in Northern Rock's assets", *The Guardian*, 23 November.
[7] Kregel, J., 2007, page 11.

The second problem that has come into light after the Northern Rock crisis fits into fraud and deception more squarely. An investigation of the Rock's ownership structure by an independent tax expert Richard Murphy revealed an artificial scheme employed by Northern Rock to disguise £50 billion through the use of an offshore trust company (Granite) – which financed Northern Rock - and an unsuspecting charity in the North-East of England, whose name was used, presumably, for financial gains, and without its knowledge. The charity however, received only one donation from staff in 2001 and was not aware of £50 billion under its name. As Murphy argues, this dodgy financing scheme "should be a concern for the Bank and the Treasury particularly if the emergency loans have actually been used to finance the activities of Granite rather than Northern Rock."[8]

It remains unclear whether official bail-out measures take into account the facts uncovered by Murphy, and what consequences it would entail for perpetrators of the scheme. It itself, the way Northern Rock crisis is being dealt with raises many issues about how private financial gains and socialised losses are related, and addressed, by political leaders. But apart from this, the Northern Rock story also raises concerns about firstly, how many other companies might be benefiting from similar schemes through the use of structured finance and complex investment pyramids. And secondly, how many companies, and to what cost, are intertwined in the complex pyramids of dodgy money. According to the *Financial Times*, lead underwriters on the Granite programme were Lehman Brothers, Merrill Lynch, and UBS; underwriters were Barclays Capital, Citigroup, JP Morgan and Morgan Stanley.[9]

The list which links the names of the world largest investment banks with an obscure, and very dodgy, financial scheme, suggests that bad debts, sub-prime lending and hence, the current crisis, is not the outcome of one malfunctioning institution, market segment, or even a financial model. Rather, it is an outcome of a political regime which has facilitated the privatisation of financial risks, at a cost of socialising its losses. In other words, a regime that made Ponzi principle a legitimate, and prominent, vehicle of modern finance. Unlike the 1920s America or 1990s Russia, however, the architects of today's

[8] Financial Times: Alphaville Blog: " The uncharitable tale of Northern Rock".
[9] FT Alfphaville, Blog Archive.

Ponzi pyramids are much harder to identify. They do not only include financial geniuses devising models in back offices across the City of London, Wall Street and Cayman Islands; they also include governments and legislation that allowed the spiral of financial innovation to get out of control.

The role of public authors and regulators finance offers another sobering lesson in financial volatility today. Precisely why and how was the sub-prime bubble allowed to inflate? Why were the worrying signs ignored? Were there any worrying signs? Below, this paper suggests that there were, but the chain of financial innovation, coupled with a sense of optimism – often propagated by politicians – made the underlying cause of fragility easy to overlook or misinterpret. That cause is to do with a complex issue of liquidity.

The beast of liquidity

Over the years, innovation in financial products and technologies has drawn praise from economists and market practitioners alike. The theory holds that new is good: competition for markets and profits encourages innovation in products, services, and most crucially, entails institutional change. Financial institutions have learned, through new tools and products, to spread risks across markets and companies, ensuring greater stability of the financial system and in the process, democratising access to credit. Yet Minsky offered a much more sombre reading of financial innovation. While adding to a sense of strength and liquidity of the individual financial units, the process of innovation shifts the system as a whole closer to the brink of a collapse and crisis. Charles Kindleberger, the great financial historian, noted that typically, it is the companies that are *the last* to adopt innovations which embody this systemic risk and bring it closer by their zealous drive for profits.[10]

Financial innovation initially does add to a sense of greater liquidity in the markets. But according to Minsky, newly introduced credit products and channels, while adding to a sense of greater liquidity in 'good times', also contribute to progressive illiquidity of the system as a whole. When the 'good times' end, this progressive illiquidity turns into a systemic crisis of unpayable

[10] Kindleberger, C., 1988, *The International Economic Order: Essays on Financial Crisis and nternational Public Goods*, Brighton: Wheatsheaf.

debts – and it can happen in a flash. Which is what happened in August 2007, and continues to unravel at the time of writing. All this, it appears, is the outcome of a long-running problem of *liquidity illusions* that had underpinned the boom of structured finance and that has become a product of financial innovation.[11] Three issues are worth mentioning here.

First, the liquidity that has vanished from the markets overnight was not exactly the same liquidity that had been sitting in the vaults of the world's central banks until early August 2007. This annoying and rather confusing fact was noted by several high-profile market analysts, but has not, as yet, been incorporated into any policy formula. The problem here is that 'liquidity' describes at the very least, three things: it is a quality of a product (or a market); it is a quantity of money available in the system, and it is the ease by which transactions can be completed in a given market. And although 'vanishing liquidity' is partly caused by the disappearance of buyers and sellers at the market, liquidity is not only about the ease and velocity of transactions; it is also about the quality of assets.

Second, as Keynes, Minsky, and many of their followers understood, liquidity of an individual portfolio or an institution is not synonymous with liquidity of the system as such. In fact, there is a trade-off between individual and systemic liquidity. Complacency and optimism about one's positions in the market contribute to greater use of leverage and in Minsky's framework, to a situation where hedged finance becomes speculative, and speculative finance becomes a Ponzi pyramid. The result is a progressively illiquid state of the market as a whole. Stretching this notion, we may argue that while every individual market is assumed to be liquid, the global financial system is progressively less so. Especially when a segment of a financial market is dominated by low-quality credit, and when this segment is tightly integrated with other financial segments.

Third, problems of diagnosing liquidity strains in time, and discerning liquidity crisis from solvency crisis – a challenge currently facing those trying to muddle through the sub-prime mess - is only part of the bigger problem. And that problem is that financial innovation, while making various tiers of the global

[11] For a more detailed discussion see Nesvetailova, A., 2008, "Liquidity Illusions and Global Financial Architecture", IPEG Working papers No, 35. www.bisa.ac.uk

credit system more interdependent, has also fragmented the global financial market. Despite moves to greater transparency promoted by international financial regulators, and the so-called information glut, one cannot fail to be baffled by the growth of opaque markets for credit risk transfer, such as credit derivatives, structured financial instruments, OTC derivatives, and offshore finance. With such a multitude of financial instruments and markets, the meaning and functions of liquidity have been stretched, while public policy tools to mitigate these developments – interest rates, monetary targets, open market operations - have largely remained the same.

It this regard, it is revealing that regulators and financiers understood immediately that the current crisis is a serious liquidity crunch. In August 2007, the central bankers of Europe, USA and Japan responded promptly to the liquidity crunch with massive credit infusions, but their initial measures were insufficient to stop the crisis from spreading. More serious fiscal stimuli offered by US president a few days ago, in turn, only distressed the markets further.

The reaction of key central bankers show that they do not believe it was a crisis resulting from a lack of information, as more orthodox formulations of finance theory hold. Indeed, market watchdogs have long been warning about the stupendous levels of bad loans and mortgages extended to US consumers. Financial analysts, including researchers at international institutions, have also been arguing that securitisation has made the tasks of discerning the ‘ends’ of a financial transaction virtually impossible.

Unlike many earlier financial crises, the current crunch is not the result of policy errors. While certainly some inept investment decisions have been made, most notably in the US mortgage market, and while the expansion of bad debts was made possible by the governmental policy of easy credit, it is not a crisis stemming chiefly from policy mistakes – at least not errors committed recently. Actually, to their credit, the principal financial regulators, including the BIS, the OECD and the Bank of England, have been warning for a while against overstretched credit and overleveraged portfolios of hedge funds. The crisis was predictable; what it showed is either the inability, or the unwillingness of regulators to intervene in the financial markets against their better judgement.

Concluding thoughts

Regulators' unwillingness to interfere in the markets is nothing new; it reflects the power of psychology driving the markets, and also pragmatism: as long as values are going up, nobody really is willing to 'prick' the bubble - the consequences may be severe. The inability of regulators to diagnose the systemic problem in time and act on it, on the other hand, is a much more serious issue. Fundamentally, it shows that either the spiral of financial innovation got out of control, or/and that the political benefits of deregulated credit markets are much higher than the social costs of financial crises - which are inevitable, as Minsky and many others would remind us. Both hypotheses raise critical political questions, most of which centre on the issue of public control over the essentially private realm of finance and credit. Central among these are questions about accountability, social costs, regulation and governance, and – perhaps most urgently – exactly how much knowledge do financial and monetary regulators have about the ways financial markets work today?

Dr Anastasia Nesvetailova teaches Global Political Economy at City University, London. She is author of ***Fragile Finance: Debt, Speculation and Crisis in the Age of Global Credit***.

City University Working Papers on Transnational Politics

Promoting the pioneering approach of City University's Centre for International Politics, this series of working papers aims to disseminate the Centre's leading-edge research into transnational politics, including all its major dimensions. Subjects covered in this series include, but are not limited to: globalization and global governance; international organizations; transnational civil society; global political economy; and the major transnational issues including development, the environment, global security, human rights, migration, and religion.

Forthcoming Papers:

D. Williams, *Governance, Security and 'Development': The Case of Moneylaundering*

P. Willetts, *The Voice of Which People? Transnational Advocacy Networks, Caucuses and Governance Networks at the United Nations*

T. R. Davies, *The Rise and Fall of Transnational Civil Society: The Evolution of International Non-Governmental Organizations since 1839*

S. Silvestri, *The Muslim Brotherhood in Europe*

Suggestions for papers welcome.
Contact the series editor, Dr Tom Davies:
tom.davies@city.ac.uk

Working Paper CUTP/002
February 2008