

The current financial crisis, monetary policy and Minsky's structural instability hypothesis.

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Abstract

In the paper it is argued that Minsky's theory of financial fragility, interpreted as a theory of structural instability, is useful to interpret the current crisis. Structural instability means that a small event can change the qualitative characteristic of a system and thus even its dynamic properties. As Minsky wrote, beyond the uncertainty arising from expected inflows and outflows what matters is the state of markets when people need to take positions in them. Before the financial crisis, though many agents were speculative and Ponzi ones, the extreme liquidity of the markets has allowed them to operate quietly for a long time. When the crisis exploded a tiny increase in the bankruptcy rate of mortgages caused the breakdown of the whole financial system. The qualitative change that followed in this case was the destruction of markets. Monetary policy had to use unusual tools in order to cope with this event. The Federal Reserve however has changed its operating procedures to overcome this problem to overcome this problem only late, as the financial crisis had already propagated to the real sector. Thus the paper concludes that the Federal Reserve did not perceive the potential danger for systemic stability of a huge unregulated short term money market and did not switch promptly enough to the new measures once the crisis started.

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