International Economic Overview

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Closing date: May 12, 2014

Minsky's Big Bang Theory

When nothing goes right in explaining economic reality, go left. As mainstream macroeconomics largely failed to predict the largest recession since the Great Depression and has not yet converged on a full explanation of its causes, many turn to heterodox economic theories to make sense of the reality we are witnessing.

And few macroeconomists have been more heterodox than Hyman Minsky, the man who stands behind economics' most famous oxymoron "Destabilizing stability". Almost three decades after his most significant contribution – Stabilizing an Unstable Economy – his Big Bang theory of debt markets is gaining momentum. Who was Minsky and can his views help us to understand the present crisis?

Born in 1919, he earned his PhD from Harvard University under the influence of another great 20th century economist, Joseph Schumpeter. Growing up during the Great Depression he was primed to spend his career studying the causes and consequences of financial crises.

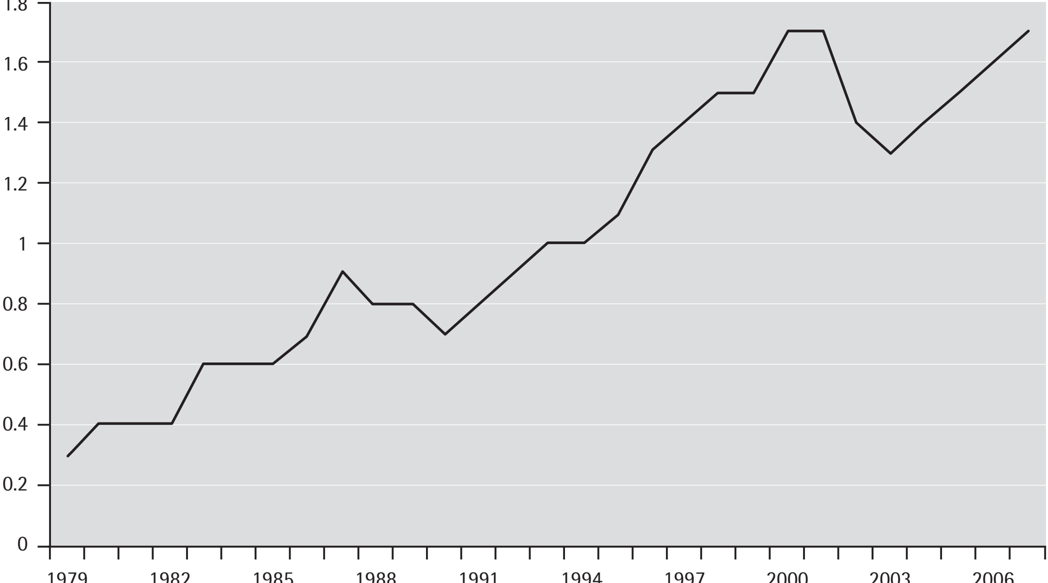
Modern macroeconomics largely views the economic system as a self-stabilizing system and looks for the causes of crises in poor institutional design (such as the implicit government support for subprime mortgages through semi-government institutions or the implicit subsidy inherent when the government bails out banks deemed "too big to fail") or external shocks (such as the oil shocks of the 70s). Minksy on the other hand was a firm believer that modern economies were fundamentally unstable, as he wrote in 1974: "A fundamental characteristic of our economy is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles."

Modern macroeconomics views the economic system as self-stabilizing, while Minsky firmly believed that economies were fundamentally unstable.

This Financial Instability Hypothesis relies upon a cash-flow approach to investment, assuming inherently irrational expectations of agents. The gist of his theory is that a sustained period of stability gives rise to optimistic expectations and a rise in speculative financing (calling upon the psychological notion of "success breeds daring"). According to Minsky, the debt structure of the economy undergoes three stages in which most financial lending is of one of three types: hedge (not to be confused with a hedge fund), speculative and Ponzi. The hedge borrower can make debt payments (covering both interest and principal) from current cash flows from investments. The speculative borrower can cover the interest from current investment cash flow to service the debt, but must regularly roll over the principal. The Ponzi borrower can only cover the interest rates by increasingly extending his borrowing.

Minsky's analysis starts during a time immediately after the end of a financial crisis. With a recent crisis in mind, investors are careful and most investment is of the safe "hedge" type. As these returns turn out well, investor confidence rises and an increasing amount of investment becomes of the "speculative" type: more risky, but not inherently unprofitable. Finally, as the last crisis has faded into distant memory and almost all investment is seen as profitable. The economy moves into its "Ponzi" style phase and small shocks can send it over the edge.

Graph 1. Securities, Commodity Contracts and Investments (% of GDP)



Source: U.S. Bureau of Economic Analysis.

The system can become so fragile that even the most miniscule shock, e.g. a rumor from the Fed that short interest rates will increase, can cause the whole system to collapse.

As the memory of the last US recession waned by the 2000s, the processes of financial innovation, deregulation and optimism induced increased appetite for risk, enabling the financial system to raise debt ceilings and leverage.

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The system can become so fragile that even the most miniscule shock, e.g. a rumor from the Fed that short interest rates will increase, can cause the whole system to collapse. As reality meets the irrational expectations, we undergo a rush to liquidity, contemporaneous drop in asset prices (both financial and real) and a drop in investments that exacerbate the financial crisis. This collapse, often referred to as the Minsky moment, has a domino effect to the extent that even within healthy hedge borrowers, deleverage becomes the common denominator. Minsky concludes by oxymoronically calling this the "destabilizing effects of stability"– indeed the financial system self-weakens itself.

Thinking about Minsky's theory, it seems straightforward to draw an analogy to the recent collapse of the US (and global) financial market. As the memory of the last US recession waned by the 2000s, the processes of financial innovation, deregulation and optimism induced increased appetite for risk, enabling the financial system to raise debt ceilings and leverage (see graph 1). By mid-2006, the market had reached its peak Ponzi stage, and slowly, by late 2006, the smarter traders started to cash in on their profits. Shortly thereafter, Lehman went under and all else is very familiar history. Some might see an analogy with the recent ongoing euro crisis.

So what does this mean? Should we abandon standard economic theory in favor of Minsky's framework? Should we severely constrain the financial sector in order to rein in its inherent fragility? Maybe, but the Minsky story makes it difficult to know for sure. The main problem is that he takes a narrative approach to macroeconomics. This is surely fine as a starting point, but without a formal framework it is impossible to properly test his theory for internal consistency and empirical validity. This means that any reader so inclined can make Minsky's framework fit with any situation of financial crisis and a theory that can predict anything predicts nothing.

This, however, does not mean that important psychological approaches to economics should be left off the table. One thing that we can surely take home from this is that one should read the history of economic thought.

Economics was not a tabula rasa prior to its mathematization in formal models, and there are interesting theories lying under the dust of library shelves that have been too easily labeled as radical or heterodox theories.

Minsky's behavioral approach could surely inspire some utility function modeling, but if we seek to make any progress these must be grounded in the same formal rigor as the rest of economics.

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How Can Spanish Borrowing Costs Be as Low as Those of the US?

For the first time since the beginning of the current crisis, the Spanish government can borrow money as cheaply as the US government can. On April 4, Spain´s five-year bond dropped as low as 1.77 percent, just below the 1.79 percent of the five-year US Treasury yield. Spain´s two-year bond yield has been to the lowest level since the early 1990s.

How is it possible that Spain, with a credit rating of Baa2 (Moody´s) and BBB (S&P), is paying less than the world´s biggest economy – which, by the way, has the top Aaa credit rating (Moody´s) and a AA+(S&P)? Things are not looking better on other fronts, either: Spain has more than one quarter of its active population currently unemployed (US unemployment is 6.7 percent[1]) and its growth prospects of 0.9 percent are way below those of 2.8 for the US[2].

Let´s try to shed some light on this mystery.

Towards the Recovery

First, data seem to indicate that the panic is over. Investors feel more confident about the recovery of Spain and the fear of its potential default has diminished significantly.

The eurozone has finally emerged from recession, with positive output growth since the second quarter of 2013. The recovery is expected to continue in 2014, with the IMF projecting a growth rate of 1.2 for the whole eurozone[2]. In countries like Spain, the recovery has been mostly export-led, but there are early signs of a shy resurgence of domestic consumption.

Still, this recovery is much more fragile than the one experienced by the US. Its domestic demand performed better than expected with strong consumption and inventories while exports continued to grow.

Hence, this incipient recovery cannot explain the borrowing costs. Even though the IMF has improved its outlook on Spain, its growth is still subdued and way below that of the US.

"Low-flation" and the ECB

In its recent World Economic Outlook Report (April 2014), the IMF emphasized its concern for the eurozone´s low inflation or even outright deflation. In the euro area, inflation has steadily declined since the end of 2011 and it has fallen below the ECB´s "danger zone" of 1 percent for 6 consecutive months. In March it fell to 0.5 percent, the lowest level since 2009.

In its report, the IMF singled out Spain as the country with a "high risk" of deflation followed by Greece and Ireland.

Deflation is dangerous because it blocks economic growth by giving incentives to consumers to postpone consumption and wait for lower prices. This leads to firms suffering declines in sales and the inability to invest. Moreover, deflation makes it harder for governments, families and companies in periphery countries still emerging from a debt crisis to repay their debts.

Even though the eurozone is far from the deflation that Japan suffered during the 1990s, its low inflation rate is a sign of the vulnerability of its economic recovery.

What has all this to do with the mystery of US and Spain´s borrowing costs? Well, first, investors are more willing to accept lower yields if they are not worried about inflation eroding the future monetary value of their investments.

Second, while the euro area is struggling with "low-flation", the US Federal Reserve has already signaled that its improving economy might bring an end to its quantitative easing policies. This implies that the Central Bank might end its purchasing of long-term bonds, lowering their prices and implying higher returns.

Finally, many investors seem to be increasingly convinced that the ECB is about to start considering the possibility of quantitative

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[1] US Bureau of Labor Statistics.
[2] IMF, World Economic Outlook, April 2014.

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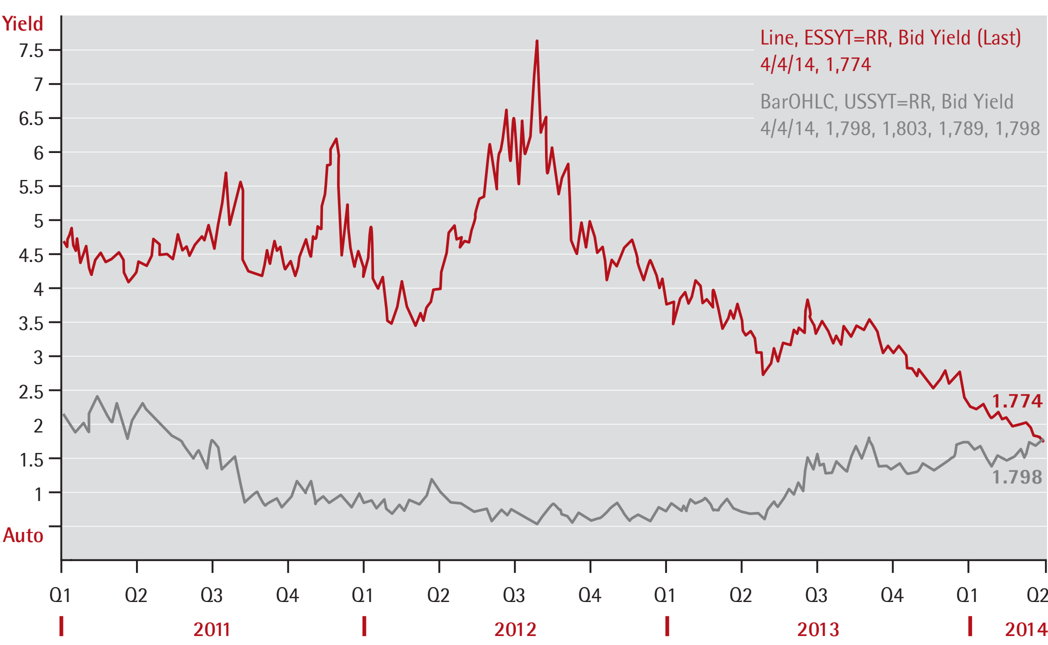
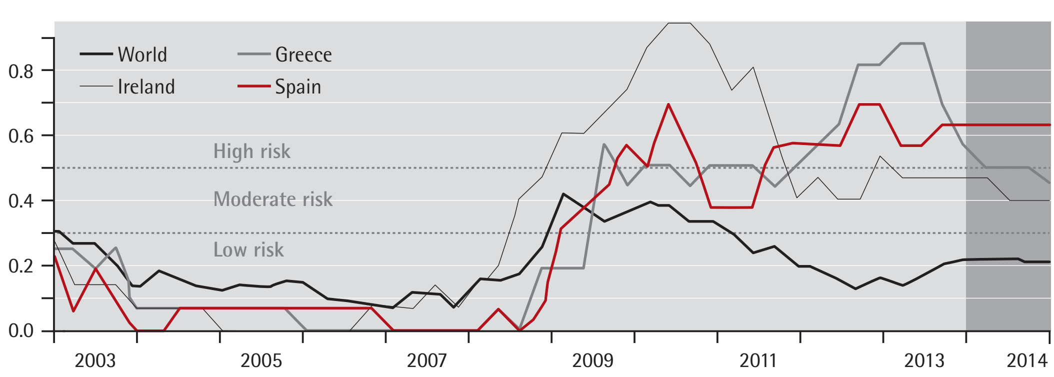
Graph 1. 5-year bond yields for the US and Spain.



Source: Bloomberg.

As the chance of Europe committing to easy-money policies remains high amid persistent low inflation, we have seen a massive spread compression in many of the periphery countries.

Graph 2. Deflation Vulnerability Index



Source: IMF, *World Economic Outlook*, April 2014.

The eurozone does not have a unified bond market and, if it decides to buy bonds, it will have to decide which bonds and from which country it will be buying.

easing and allow for some version of bond-buying in the EU. Even the Bundesbank, the German Central Bank, has softened its tone with its president stating that he did not rule out some form of quantitative easing.

As the chance of Europe committing to easy-money policies remains high amid persistent low inflation, we have seen a massive spread compression in many of the periphery countries. Italy's borrowing costs dropped to a record low and Greece returned to the bond market after four years with a demand for its bonds greatly oversubscribed.

However, the risks remain. On the one hand, the recovery is still fragile. On the other hand, quantitative easing is much more complicated for the ECB than for the Federal Reserve. The eurozone does not have a unified bond market and, if it decides to buy bonds, it will have to decide which bonds and from which country it will be buying. We will hear a lot more about this in the coming weeks.

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Let's Say I'm Talking About Spain

1. Once upon a time there was a country – an easily identifiable one – that before the global financial crisis managed to accumulate an external imbalance of over 10 percent of GDP. At the time, it was the second biggest deficit in the world, both in nominal and relative terms. In absolute terms, its deficit was second only to the U.S.'s balance of payments deficit (an economy 15 times larger), while in relative terms, it was beaten only by Iceland, a country that ended up facing economic meltdown, with its public administrators facing criminal charges.

The staggering size of that balance of payments deficit meant that the government had to rely on foreign savings to finance its out-of-control public spending. In practice, the existence of a severe imbalance in the balance of payments merely indicates that internal spending is greater than the total revenues generated and as a result "someone" from overseas must step in to cover the financial excess.

But what, or perhaps better put "who," was responsible for this vast excess? It certainly was not the public sector, which repeatedly reported a surplus in its accounts, with tax revenues comfortably exceeding total public spending year in, year out. The problem was almost exclusively the fault of the private sector, where the excess of consumption and investment (or, as economists like to say, "the gap between savings and capital formation") surpassed a staggering 11 percent of GDP.

When the global financial crisis erupted, the financial flows into the country – a country that, as you already know, is called "Spain" – suddenly ran dry. To correct the imbalance, there was little option but to reduce aggregate spending, regardless of the pain and suffering it would cause. However, the public sector, in time-honored Keynesian fashion, saw its mission as the exact opposite – that is, to artificially increase spending so as to prevent the inevitable impoverishment, as if the economic storms were merely a passing phenomenon. As such, the full brunt of the adjustment fell on the broad shoulders of the private sector, to which most of the blame was attributed for the country's financial crisis. And as a matter of fact, civil society took so much to the task that in the short space of three years the private sector was showing a surplus of 6 percent of GDP – a figure that would increase by 2.5 percentage points over the course of 2013. It was a historic turnaround, representing savings of more than 19 percentage points of GDP.

Granted, the resulting economic pain could have been distributed more equitably, primarily through the reduction of salaries, but the unions blocked all such efforts. Incumbent workers jealously clung to their standard of living, with the result that 5 million citizens were dumped on the dole. The social cost was unbearable and despite stiff resistance, salaries eventually began falling, while unemployment – as economic law dictates – increased in line with the marginal productivity of work. Lower salaries coupled with rising productivity inevitably leads to reduced per-unit labor costs, thanks to which the Spanish economy was able to regain its competitiveness and, with it, correct its external imbalances.

Without the luxury of monetary devaluation and through sheer internal efforts, the country has managed to rebalance its economy – and without the continued assistance of overseas funds. Quite the contrary: the country is now in the enviable position of exporting capital abroad. Historically speaking, no country has made such a great sacrifice in such little time – no mean feat, albeit at huge social cost that could, indeed should, have been substantially mitigated.

2. Once upon a time there was a country – also easily identifiable – where the financial entities, and in particular its savings banks, had taken on huge risks in just one sector – real estate – whose eventual collapse would devastate both lenders and borrowers alike. The savings banks accounted for roughly half of the total system, with the result that their collapse would set off alarm bells across international markets.

As an aside, it's worth recalling the diligence and effectiveness with which the U.S. government and Federal Reserve had acted to stem the problems of its financial system. By contrast, the eurozone lacked both the structures and mechanisms to confront the economic

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In 2009, 90 percent of Spanish banking assets were held by 51 banks; three years later the same proportion of assets are now held by just 13 institutions, all of which are now structured as commercial banks.

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crisis with the necessary speed or agility. In the case of Spain, the country failed to respond with any of the urgency or efficiency shown by the U.S. Since the beginning of the crisis, Spanish credit institutions have loaded up their accounts with a volume of provisions equivalent to 25 percent of GDP. Once the bubble popped Spanish banks required a cleansing of their balances of unprecedented proportions.

Drawing on funds provided by Spanish taxpayers and lent by the ESM (European Stability Mechanism), the government of Spain recapitalized the saving banks with more than 55 billion euros. Funds were also provided by the nation's "good banks" as well as in the capital markets through new share offers. In this way, the credit system was cleaned up and recapitalized in a ring-fence operation on a heretofore unimaginable scale.

This all went hand-in-hand with a thorough reconstructing of the system. In 2009, 90 percent of banking assets were held by 51 banks; three years later the same proportion of assets are now held by just 13 institutions, all of which are now structured as commercial banks. To reduce the sector's excess capacity, the other 38 institutions disappeared or were merged with or taken over by healthy entities.

It's not out of the question that, despite all the restructuring and recapitalization programs, the European Central Bank (ECB) might demand further targeted restructuring efforts in its upcoming stress tests. We will soon see. That said, it's no exaggeration to state that scant countries have ever carried out a program of banking consolidation on such a scale and in such a short period of time.

3. Once upon a time there was a country – you know which one – whose capacity to remain within the framework of the European single currency was assigned a probability of less than 50 percent by assorted economists, wealth managers, directors of pension funds, hedge fund owners and venture capital executives. Those fears were reinforced by the rapid deterioration of the ratings of Spanish bonds by the three big rating agencies, Moody's, Standard & Poor and Fitch, as well as the dizzying rise of risk premiums, for both Spanish sovereign and corporate debt.

In the best-case scenario, the country would only be able to remain in the eurozone if it received a massive influx of funds from multinational organizations – meaning wholesale financial support aimed at propping up its sovereign and corporate debt while allowing for a thorough cleansing of its financial system. In return, the country would have to accept a program of conditionality comprising deep structural reforms. This would have entailed quarterly supervision and control of the country's finances by the International Monetary Fund (IMF) and its Troika partners.

But that's not how it happened. With the determination and steely pride of a bullfighter, the country embarked of its own accord on a sweeping program of internal devaluation and financial sector restructuring. Granted, it needed some financial support upfront, but much less than was originally feared and without the usual program of structural conditions imposed by multilateral lenders. The country also implemented a program of partial structural reforms – reforms that it was said would not be tolerated by the civil society unless they were imposed by international institutions. The result of this bullfighter spirit is that, just a few years after the crisis, the country has completely turned around the situation of its balance of payments, far surpassing even the most optimistic forecasts of a few years back. As a direct consequence, the Bank of Spain's net position with the ECB has dramatically improved. The rest, as they say, is history, including the terrible social costs.

4. We should make sure that such a traumatic experience is not lost in oblivion without extracting some vital lessons, of which there are numerous. However, given the limited space I have left I will have to boil them down to five fundamental points:

1. When an economy requires an overhaul, it should not be limited to merely one of its macro-sectors. Both the private and public sectors must take part in the process in order to achieve the necessary structural equilibrium.

2. The restructuring of the financial system must be undertaken straight away. Refusing to recognize the weaknesses or putting off addressing them to a later date merely aggravates the economic downturn, eventually turning it into a deep, costly and enduring

recession. Economic theory of cycles provides abundant empirical data on this respect.

3. The job market, like any other market, can face its own inevitable imbalances via “prices” or “quantity”. If you choose the first path, real salaries will fall, but unemployment can be maintained at reasonable levels. If you opt for the latter, salaries may remain unchanged, but unemployment will rise significantly, making it much more difficult to generate a recovery in consumption.

4. Requesting external assistance from multilateral organizations (which exist for that precise purpose) may be a bitter pill for national governments, but as history shows, time and again, when you operate with the technical and financial assistance of the IMF and other entities, not only are the financial costs lower (through the extension of “soft” credits), but the economy adjusts more quickly, with greater depth and in a more balanced way than if you tackle the problems alone. In short, the urban legend of "men in black" is not borne out by historic experience.

5. Whatever the path chosen, adjusting the economy is complicated. However, with sufficient will and determination, it can be done relatively swiftly. Relaunching the economy, however, is a whole different matter. It requires time, patience, a rebalancing of public accounts, common sense, energetic reforms and tenacity when it comes to developing business-friendly policies. In the end, there’s no other way for the economic system to regain lost trust and begin supporting new investment and growth projects. Not even the Spanish economy could manage it, even with its bullfighting spirit.

Adjusting the economy is complicated, but with sufficient will and determination, it can be done. Relaunching the economy, however, requires time, patience, a rebalancing of public accounts, common sense, energetic reforms and tenacity when it comes to developing business-friendly policies.

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Selected Activities

ALUMNI

Economic Briefing on Asia and ASEAN Economic Community

London, May 20
Prof. Bernardo Villegas

By 2015, the 10 nations that belong to the Association of Southeast Asian Nations will constitute the ASEAN Economic Community with a free flow of goods, services, capital, labor and other resources. This AEC would have a total consumer market of some 650 million people, rapidly graduating to middle-class status in the next 10 to 20 years, following closely the experience of the EEC in the last century.

Three countries alone, the so-called VIP (Vietnam, Indonesia and the Philippines) will account for two-thirds of the entire market. All three would have the advantage of a young and growing population in the midst of a rapidly aging East Asia. The emerging markets of the ASEAN have abundant natural resources and are expected to be main providers of food – the most critical resource in the coming years – for such countries as China, Japan, and South Korea. The ASEAN markets themselves will be very attractive for investors in infrastructures, mineral resources, agribusiness, tourism, logistics, health care, and education.

Dealing with Risk and Complexity

Warsaw, May 22
Prof. Rafael de Santiago

In this session, Prof. Rafael de Santiago will discuss strategies for taking decisions in uncertain conditions. Prof. de Santiago is professor and Department Chair of IESE's Managerial Decision Sciences Department.

Business Leadership and Governance: What Have We Learned Five Years After the Financial Crisis?

Boston, May 22
IESE Dean Jordi Canals

Dean Jordi Canals will deliver a special session on examining business leadership and governance in the current context.

Personal Financial Planning

Brussels, May 22
Prof. Ahmad Rahnema

We seem to be much better prepared at taking care of our health than our money. This is hardly surprising. Neither our schools nor our universities offer courses on personal finance. The fact is that nobody really cares about your financial education. Add to this the existing perception that financial planning is a really onerous and complex process and it is no wonder that many people are scared off. Certainly there are many players with massive hidden agendas that would have us believe that financial planning is incredibly complex and that you need significant funds and complicated models to do it. However, as the title suggests, this session aims to change the perception that financial planning is only for the wealthy and super intelligent! Everyone should have a financial plan.

The New Science of Positive Leadership

Milan, May 22
Prof. Alberto Ribera

Prof. Alberto Ribera will deliver a talk in Milan on the topic of positive leadership practices. Prof. Ribera is the academic director of the IESE Coaching Unit and teaches the MBA course "Personality and Leadership."

Mobile Payments: The Next Big Thing or Yet Another Tech Hype?

Dusseldorf, May 28
Prof. Eduard Calvo

Paying your coffee, getting on the subway, or splitting the bill of your last dinner with friends are common actions that can now be done using a cellphone somewhere in the world. This is not yet another interesting potential feature of your device: in 2010, more than $30 billion were involved in mobile transactions, and there is consensus that this figure will increase exponentially. During the session we will discuss the implications of mobile payments on several industries and review some successful business models that are taking off globally.

SHORT FOCUSED PROGRAMS

Value Creation Through Effective Boards

Barcelona, May 18-21

On this program, held jointly with Harvard Business School, you will discover how to strengthen your own contribution and improve overall board effectiveness to truly drive business values, competitive advantage and board engagement. You will also learn techniques to truly harness the values and power of your board through design and optimized internal function.

Getting Things Done

Barcelona, May 20-23

Unlock the mysteries behind strategy implementation and discover the essential factors crucial in bringing about the successful execution of business objectives. When a business strategy fails, shortcomings are often exposed – not necessarily in the strategy itself – but in its execution. The ability to get things done is critical for business leaders and it is the overriding factor in determining a company's long-term success.

This program features the expertise of IESE Professors Fabrizio Ferraro (Academic Director), Antonio Dávila and Marco Tortoriello, as well as the vast experience of Stanford University Professor Jeffrey Pfeffer, a world-renowned expert on management, leadership and human resources.

Developing Leadership Competencies

Barcelona, May 27-30

The success of a company and its ability to maintain its competitive edge depend fundamentally on the talent of its people. The leadership skills acquired in this program give participants the ability to nurture and maximize this crucial asset. Participants are given individual feedback on their personal leadership capabilities and style, and are shown how to design personal development plans and strategies aimed at engaging team members to achieve corporate goals.

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