

MINSKY'S PARADOX: AFTER CRISIS, BEFORE CRISIS?
(as a preface)

This publication is already the 18th collection "*Eesti majanduspoliitilised väitlused*" (Discussions on Estonian Economic Policy). The full versions of the papers have been published on the CD-ROM enclosed with the collection, and the collection contains the abstracts of the papers.¹ To ensure the quality, the papers have first been anonymously peer-reviewed by Estonian and foreign economists. The collections are published in mutual cooperation by the publishing house Berliner Wissenschafts-Verlag (former Berlin-Verlag Arno Spitz) and the Estonian publisher Mattimar OÜ.

The aim of the papers is to analyse and assess the economic developments going on in the European Union and to draw conclusions from them from the aspects of economic policy and also concerning the main elements of the political order, if appropriate. This has become particularly important in the period after the global financial and economic crisis.

The income tax rate currently effective in Estonia is uniform and relatively low (21%), i.e. Estonia has a proportional income tax system and corporate retained earnings are even fully tax-free to favour corporate investments, improve the international competitiveness of the state and attract also foreign investors. These measures were successful at first. Estonia, similar to Latvia and Lithuania, achieved a two-digit GDP growth rate in some years. The global financial crisis and the resulting economic crisis put an abrupt end to their development. The economic development of Estonia and the two other Baltic states has had its most serious setbacks during the period after regaining their independence.² While before the crisis the budgets of the Estonian public sector were characterised by a clear surplus, which reduced the public debt to 3.5 per cent of the GDP, the current development has been in the opposite direction. The confidence of investors has dramatically decreased.

One of the problems of Estonia may consist in the fixed exchange rate against euro. As Estonia is making efforts to join the monetary union as soon as possible, it is keeping up the currency board system which comes from the times of the German mark and which the European Central Bank continues to accept with respect to Estonia also after Germany has adopted euro. According to the currency board system, the Bank of Estonia is obliged to intervene in the market of euro and kroon at any time for the stabilisation of its own currency, if appropriate. This raises the question of whether devaluation of the Estonian kroon would have been able to significantly support the economic development. On the one hand, devaluation may have improved the international competitiveness of Estonia and thus enlivened consumer demand at the expense of foreign trade. On the other hand it is questionable whether considerable enlivening would have been achieved due to the

¹ According to the author's choice either in Estonian, German or English.

² The GDP of Estonia had decreased by 15.6 percent in the third quarter of 2009 compared to the previous year (Bank of Estonia and Statistics Estonia).

relatively low dependence of Estonia on exports. Besides, we have to take into account the fact that more than 90 per cent of foreign loans have been obtained on the basis of euro, therefore servicing of loans of Estonia would have become much more expensive as the credit rating agency Standard & Poor's (S&P) lowered the credit rating of Estonia from level A to A-.

If we want to curb the devastating developments of the recent years which started with the crisis caused by high risk mortgages, we have to ask what has been done to prevent the recurrence of such crises. As the trouble started from financial affairs, the reformers are obviously focusing on it now. The most important understanding reached was that money markets are so important for national economy these days that they can no longer be left at the mercy of market forces but should be regulated. Otherwise financial markets may shift again and the general public will have to bear the losses again with huge resources in order to prevent a full collapse. This means that people eventually have to bear the burden.

The regulation should start with the credit rating agencies. In the future, they should be registered by a supranational agency and subjected to strict rules of evaluation and constant supervision. It is important to ensure that granting ratings and counselling would be strictly separated to avoid conflicts of interests.

More extensive requirements would be directed to prohibition of purely speculative mutual trade in securities and derivatives between credit institutions as this is no longer related to real economy. Also their participation in hedge funds and in companies which invest in venture capital should be prohibited. For this purpose, commercial banks and investment banks should be separated to enable commercial banks to engage in their main activities again³. Their equity has to be sizeable enough to cover the remaining risks.

The other changes would be the following:

- the fixed salaries of management and supervisory board members should be restricted or their recording as expenses for corporate taxation allowed only to the extent of a certain maximum amount;
- the amounts of bonuses of directors and other executives should be fixed for longer periods (three years as a minimum) and they should not exceed e.g. 30 per cent of their fixed basic salaries;
- members of management and supervisory boards should be responsible for the mistakes of their companies (lose their bonuses or even fixed basic salaries, if appropriate);
- if executives get a part of their salary as participation rights in their company, they would be able to sell them only after a certain period, which should not be too short, to make executives adopt decisions for not just short-term success but proceeding from sustainable goals;

³ Namely in depositing and lending which is essentially mediation between the purchase powers of capital investors and borrowers.

- the requirement to restrict at least the size of credit institutions to prevent them from setting whole national economies at risk and ripping off countries as important elements of their systems so that the tax-payer eventually has to pay for their management mistakes, has given rise to heated disputes.⁴

It is questionable whether implementation of all these proposals for reforms would help to prevent in the future crises similar to those which hit national economies in the recent years. Already in the 70s of the last century, Hyman Minsky referred to the phenomenon which has now been rediscovered as the Minsky's paradox⁵ and is proved correct by the developments of the recent years. According to Minsky's paradox, in market economies where decision-making processes of entrepreneurs, banks and households⁶ are fully decentralised, the financial systems will become increasingly destabilized with each phase of expansive economic development. The root of all evil is the increase in the debt burden of the private sector during periods of overheated economy. In the initial phase of the boom, market participants at first act carefully, ensuring that the objects financed are profitable enough and that current revenues are sufficient for servicing loans without problems. When the economy becomes more heated and the revenues are increased by inflation, people become more thoughtless. Success makes them bolder to take bigger risks. Market participants underestimate risks, overestimating their profit opportunities at the same time. Gambling becomes increasingly reckless and finally reaches dangerous magnitudes. Soon it is enough to have cash flows cover just the interest payments; it seems that loans can be extended and restructured without problems, after all. If such a development reaches extensive dimensions, interest payments can only be financed with new loans. After that they rely on money markets to finance their financing needs, as the value of the assets used as a security is still growing. But if this is suddenly not the case any more, everything will fall apart. Loss of trust becomes wide-spread in the economy, supply in money markets dramatically decreases and the downward spiral begins. The unstable financing system pulls also the real economy to the abyss with it.

This is exactly what the financial crisis which started in the U.S. real estate market in 2007 and spread all over the world after the collapse of the Lehman Brothers Investment Bank in autumn 2008 was like. The neoclassicist belief in the functioning of free markets, a stable balance and unmistakably rational behaviour of market participants proved deceptive. As the greed for increasingly higher profits and power and the resulting instability cannot be excluded in the future either, it is

⁴ Among others: Eesti majanduspoliitilised väitlused, issue of 2009, preface, pp. 15 ff.

⁵ "Stability is destabilizing!" See in addition: Minsky, P. Hyman, John Maynard Keynes – Finanzierungsprozesse, Investitionen und Instabilität des Kapitalismus, (1975) 2008 (Metropolis); idem, Die Hypothese der finanziellen Instabilität, Challenge, White Plains, N. Y. 1977, lk 20 jj; idem, The Financial Instability: Handbook of Radical Political Economy, Philip Arestis & Malcolm Sawyer (Hrsg.), 1993; idem, Stabilizing An Unstable Economy, 1986 (Yale University Press), 2008 (Quebecor World); idem, Can "It" Happen Again? Essays on Instability and Finance, New York 1982.

⁶ Therefore instability of economic development is actually unavoidable.

important to create solid public institutions who would be able to monitor the fulfilment of reform requirements by the economic sector and also perform stabilising interventions, if appropriate. Central banks have a key role here, inspecting the increasingly complicated financial systems and managing the development of new financial structures. At the time of globalisation also international coordination is unavoidable to prevent financial market participants from avoiding the regulations of national supervisory institutions and taking advantage of a supervisory agency of one country at the expense of another. It is important to establish common global standards which would make it possible to prevent excesses in money markets without impairing the functioning of the lending system.

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