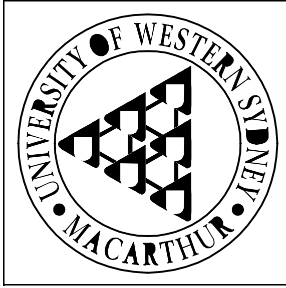

UNIVERSITY OF WESTERN SYDNEY
Macarthur

Faculty of Business & Technology

Subject: Supplementary Remarks December 7th 1996

Mr Stan Wallis,

Chairman,

Financial System Inquiry

Dear Mr Wallis,

Thank you for the opportunity to present my views personally to your Committee yesterday. There were two points on which I was not satisfied with the quality of answers I gave to questions from the Committee, and I am writing this note to attempt to improve upon yesterday's performance.

(1) Substance of Minsky's theory

The first point was a question about the substance of Minsky's theory. My answer attempted to transfer its gist—which is the ability of borrowers to commit themselves to more debt during booms than they are capable of repaying during slumps. While this is a core concept, Minsky's theory is much richer than that, and is seen by some economists as being a far more accurate interpretation of Keynes's *General Theory* than that which found its way into the textbooks.

The paper from the *Journal of Post Keynesian Economics* which I tendered at yesterday's hearing provides this argument, and I would suggest that any Committee members who are interested in this issue consult that paper. Should anyone wish to investigate the veracity of the claims I make there, I would suggest the following papers:

- Keynes, J.M, 1937 "The general theory of employment", *Quarterly Journal of Economics*, pp. 209-223;
- Hicks, J.R., 1937, "Mr Keynes and the Classics", *Economica*, pp. 147-159.
- Hicks, J.R., 1982, "IS-LM—An Explanation" in *Money, Interest and Wages*, Blackwell, Oxford.
- For a more detailed presentation of Minsky's theories, the two best references are:
    - Minsky, H., 1975, *John Maynard Keynes*, Columbia University Press.

- Minsky, H., 1982, *Inflation, Recession and Economic Policy*, Wheatsheaf, Sussex.

The former is the main reference; the latter is a collection of Minsky's papers, where the Financial Instability Hypothesis is stated rather succinctly.

(2) The impact of securitisation

The securitisation of debt documents such as residential mortgages does not alter the key issue, which is the ability of borrowers to commit themselves to debt on the basis of "euphoric" expectations during an asset price boom. The ability of such borrowers to repay their debt is dependent upon the maintenance of the boom, and as the share market reactions to yesterday's comments by Alan Greenspan reminded us, such conditions cannot be maintained indefinitely.

Should a substantial proportion of eligible assets (e.g., residential houses during a real estate boom like that of 87-89) be financed by securitised instruments, the inability of borrowers to pay their debts on a large scale will not, of course, directly affect liquidity in the same fashion that a failure of bank debtors does. Instead, the impact will be felt by those who purchased the securities, or by insurance firms who underwrote the repayment.

- Where this is a government, the impact on liquidity will again be slight, since public debt will replace private.

- Where this is a financial institution, such as a bank, it will be in a very similar situation to the State Bank of Victoria (and many others) after the last real estate crash, with similar consequences.

- Where this is an insurance company, it could be driven into bankruptcy, with an impact on liquidity via its shareholders and its own creditors. However this would not be as serious as the second instance above.

- Where the securities are tradeable, there would obviously be a collapse in the tradeable price, and, potentially, the bankrupting of many of the investors—depending again on their own financing arrangements.

Overall I would agree that direct regulation of securitisers is not warranted. What is needed instead is prudential overview of the extent to which banks, insurance firms and superannuation institutions invest in securitisers and their products. However, I would object strongly to the proposal from Aussie Home Loans (p. 135, paragraph 5.94) that securitisers should be able to call themselves banks.

Yours sincerely,

Dr Steve Keen
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and Finance