Comments on "Perspective on the Credit Slowdown"

The Minsky Cycle in Action: But Why?

*by Benjamin M. Friedman**

One of the things economists most dislike talking about is people's attitudes But that does not make them any less important in accounting for the behavior economists seek to understand

The subtheme that continually struggles to poke its head above the surface of Richard Cantor and John Wenninger's useful review of recent experience in the U S. credit markets is the radical change in attitude toward the use of debt that occurred at the outset of the 1983-90 business expansion. As Cantor and Wenninger's detailed recounting of that experience makes clear, on both the demand side and the supply side the credit contraction of 1990-92 was a direct consequence of the dramatic increase in proclivity toward leverage during the preceding half-decade While it is easy to point to one or another factor of an objective kind that may have played some minor role in accounting for that increased proclivity toward leverage, none seems capable of having motivated the truly massive change in business financing practices that occurred. We are therefore left, I believe, with a change in practice driven largely by a change in attitude among the practitioners And as Hyman Minsky correctly argued years ago, changes of this kind, especially in the credit markets, inevitably breed their own reversal.[1]

*William Joseph Maier Professor of Political Economy, Harvard University

[1]Hyman Minsky, "The Financial Instability Hypothesis An Interpretation of Keynes and an Alternative to 'Standard' Theory," *Nebraska Journal of Economics and Business*, 16 (Winter 1977), 5-16

The major part of Cantor and Wenninger's effort in this paper lies in documenting the credit market developments surrounding the 1990-91 recession and the unusually slow recovery that followed The chief burden of their analysis is to show that the slowdown in credit extensions during this period—a slowdown of a magnitude and breadth that had been unprecedented in the post-World War II era—reflected a contractionary tendency on the part of lenders as well as borrowers. Given the well-known difficulties of identifying shifts in credit supply behavior, the evidence they produce bears this burden reasonably well

Unraveling the separate roles of supply and demand can be a challenging task in any market setting. Credit markets are even more problematic in this context, however, not only because the observable price of credit (the interest rate on a loan) is typically but one element among many that together constitute the relevant price as seen by borrowers and lenders, but also—and more fundamentally—because credit market phenomena importantly affect economic activity at the aggregate level Suppose, for example, that the only shock to the economy has been a sharp reduction in lenders' willingness to advance credit, and that this negative shock to credit supply has induced a decline in aggregate economic activity. Further suppose that the resulting decline in aggregate activity has in turn induced potential borrowers to demand less credit (because credit demand is plausibly conditional not just on price but also on the volume of business to be financed). Then both bankers and economists may accurately report that the weakness of lending volume was largely due to the absence of loan demand, even though in a more basic sense the only shock that disturbed the economy was to loan supply. Indeed, in the presence of noisy measurements, the econometrician in this case could even find that that part of the weakness in credit volume attributable to supply behavior was not statistically different from zero at standard significance levels, and therefore conclude that weak demand was the *only* force at work.

How, then, should we assess evidence of the kind emphasized by Cantor and Wenninger—or, similarly, by other recent explorers of this question such as Ben Bernanke and Cara Lown?[2] To be sure, their research has not identified unambiguous proof of a disruption to credit supply. Instead, the evidence is suggestive and indirect. But in light of the difficulties to which this line of inquiry is necessarily subject, and in the wake of decades of unsuccessful attempts to document "credit rationing" and other analogous phenomena, I am inclined to see this glass as more half-full than half-empty I think Cantor and Wenninger are right to conclude that a contraction of lenders' willingness to lend accounts for a material part of the actual credit slowdown we have experienced, and right also to suggest that this restrictiveness of credit supply may well have retarded nonfinancial economic activity in the period under study.

The more over-reaching objective of Cantor and Wenninger's paper, of course, is to gain an understanding of just how all this came about Explicitly placing their analysis in the context of Minsky's contributions, they argue that credit demand and credit supply have *both* contracted in large part as a consequence of the enormous increase in credit borrowed and lent during the latter half of the 1980s. Many borrowers, especially businesses but also including some individuals, had expanded their liabilities to the point that their earnings streams, even under the most optimistic expectations, were insufficient to service yet additional obligations Many lenders had stretched their balance sheets to the breaking point, and many of these actually experienced just such a break when their customers' inability to meet the obligations they had incurred fractured their own capital positions. Just as Minsky described, the proclivity toward greater debt eventually ran to excess. And also as Minsky described, that excess bred its own reversal.

But the deeper question, raised by Minsky but never satisfactorily answered, remains: Why did the credit excess of this earlier period achieve such extraordinary momentum in the first place? Why did the American business and financial communities turn their backs on balance sheet and interest coverage norms that had governed their behavior for decades? How did bankruptcy and default evolve from a mortifying embarrassment, indelibly staining a corporate manager's record (if not personal integrity as well), into a conventional way of doing business? What accounted for the metamorphosis of "sound finance" from a precept to an epithet?

The distinguishing hallmark of the 1980s leverage movement is that it was just that. an increase in *leverage*. In particular, it was not the financing of an investment boom. While American businesses borrowed in record volume during the mid- to latter 1980s, these years were a poor period for investment in new earning assets. Of just over $1 trillion in net new borrowing undertaken by U.S nonfinancial corporations during 1984-89, almost $600 billion went into acquisitions, leveraged buyouts, stock buybacks, and other forms of equity paydowns. Although this move to greater leverage is implicit in much of what Cantor and Wenninger write, it is curious that, at the end of their paper, they begin their ten-step outline of the "credit cycle" by positing an increase in capital investment. That is simply not what happened in the 1980s. There was no surge in the demand for investment Instead, there was a surge in the demand for leverage

Once the leverage phenomenon gathered momentum, it is easy enough to see why lenders willingly played their role in financing it. Cantor and Wenninger correctly note (although I wish they had emphasized it more) the perverse incentives created by the combination of deposit insurance and limited liability Given these perverse incentives, effective regulation and supervision assume paramount importance, especially for thinly capitalized depository intermediaries. But of course, as they point out, lax regulation and inadequate supervision were also part of the order of the day; the radical change in attitudes toward debt in the 1980s extended to the public sector as well, and not just in the now all too familiar sense of chronically irresponsible fiscal policy. Placed in perspective, Cantor and Wenninger's negative conclusion on the role of technological advances in facilitating these financial activities is a further reflection of the same general point: when incentives are perverse, both deregulation and technological innovation—or, for that matter, anything else that renders market participants more readily able to respond to those incentives—do not necessarily lead to improved outcomes. Finally, the competitive pressure on financial institutions that themselves must compete in a speculative market to obtain the capital that is the essential raw material of any intermediary's business throws up yet further perverse incentives to buttress

[2]Ben S Bernanke and Cara S Lown, "The Credit Crunch," *Brooking Papers on Economic Activity*, 1991 2, 205-39

those already created by deposit insurance and limited liability. Once even a few lenders assume dangerously aggressive postures, it becomes entirely rational—indeed, competitively necessary—for others to do so as well. In sum, there was no lack of incentives for lenders to finance even patently excessive demands for credit, as long as they were both able and allowed to do so.

At the same time, there was also no lack of intellectual rationalizations for ever greater credit demands as leverage rose Michael Jensen, for example, suggested several apparently plausible reasons why higher leverage was potentially in the economy's interest.[3] Jensen's basic argument was that debt creation without retention of proceeds would reduce firms' net free cash flow, thereby increasing internal incentives to efficiency and, over time, increasing profitability and hence the ability to service the added debt. Further, highly levered capital structures would reduce creditors' incentive to force liquidation in the event that these anticipated efficiency gains, and consequent higher earnings, did not materialize. While Steven Kaplan and others have found some statistically significant evidence to support the first contention, the economically significant point is that too few borrowers actually generated the higher earnings that would have been necessary to avoid the debt problems discussed at length by Cantor and Wenninger.[4] And when they did not, the fact that liquidation was not the dominant option was of small comfort to the lenders that had advanced the funds and subsequently took the losses.

The leverage movement of the 1980s therefore proceeded along just the path Minsky had suggested. The flow accelerated until it became a flood. As it gathered momentum, it also became less discriminating. Firms that underwent leverage-increasing transactions during 1984-86 differed on average from those that did not, along several familiar dimensions indicating the likely existence of unused debt capacity. Leveraged buyout targets during these early years tended to have more stable cash flows, or more need to shelter earnings from taxation, or larger working capital positions relative to total capitalization, than otherwise comparable firms that did not undergo leveraged buyouts. By 1987-89, however, these differences had vanished. Firms taking on higher leverage were largely indistinguishable from other firms, except for the higher leverage itself.[5] The aftermath—the endogenous reversal, as theorized by Minsky—was the overburdened nonfinancial sector and the weakened credit-creating institutions described by Cantor and Wenninger.

Gordon Wood, in his recent prize-winning book on the American Revolution and its consequences for our nation in its infancy, concluded that the numerous bankruptcies and financial collapses of the 1790s contributed greatly to the democratization of American society.[6] I doubt, however, that many citizens—and certainly not many of our central bankers—would today welcome a further round of democratization achieved by this mechanism.

In the end, we have a fairly coherent story of what happened in the 1980s, and then during the most recent few years, but the fundamental question still remains: why? Why the enormous change in attitude toward debt in the first place? Minsky never explained it. It is hardly a severe criticism to report that Cantor and Wenninger haven't either

[3]Michael C Jensen, "Agency Costs of Free Cash Flow, Corporation Finance and Takeovers," *American Economic Review*, 76 (May 1986), 323-29

[4]Steven Kaplan, "Management Buyouts Efficiency Gains or Value Transfers," Harvard Business School, 1987, mimeo

[5]Christopher J Fox, *Changes in the Insolvency Risk of LBO Transactions Evidence from the 1980s*, unpublished thesis, Harvard University, 1990

[6]Gordon S Wood, *The Radicalism of the American Revolution* (New York Alfred A Knopf, 1992)