What causes financial crises?

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In a narrow sense, the global financial crisis of 2008 was unprecedented. It was the result of a range of problems that had built up over time: light regulation of banks, overly complex credit products, tighter cross-border linkages and irrational exuberance in the housing market. But while that precise combination of factors had never been seen before, the trajectory from excessive risk-taking to financial chaos was a familiar one, whether to students of America's volatile banking industry in the 19th century or to investors who remembered Asia's woes in the late 1990s. Each crisis is unique, but meltdowns occur regularly enough that they exhibit certain patterns. What causes financial crises?

It is a big question. For decades, though, it was one that economists rarely discussed. Sure, there were stockmarket bubbles and currency crashes, but central banks seemed to have perfected their responses, preventing the emergence of systemic crises. Finance, a sub-discipline of economics, focused on topics such as how to price assets. The carnage of 2008 changed that. Economists, investors and central bankers turned back to the big question. One answer, which had been crafted decades earlier but largely marginalised, received more attention than most: Hyman Minsky's financial-instability hypothesis. Having grown up during the Great Depression and served on a bank board, seeing first-hand how risky a business it could be, his was a scepticism informed by experience.

Starting with a look at how companies pay for investment, Mr Minsky described three kinds of financing. The first, which he called hedge financing, is the safest: companies can repay debts with their earnings. They have limited borrowings and good profits. The second, speculative financing, is a little riskier: companies can cover their interest payments but must roll over their principal. This works fine normally but not in downturns. The third, Ponzi financing, is the most dangerous. Earnings cover neither principal nor interest; firms are betting that their assets will appreciate. If not, they are in trouble. Economies dominated by hedge financing—those with strong cashflows and low debt levels—are stable. When speculative and, especially, Ponzi financing become popular, economies are vulnerable. If asset values fall, overstretched investors must sell their positions. This further hits asset values, causing pain for even more investors, and so on—a downward spiral now sometimes called a "Minsky moment". Investors would have done better to stick to hedge financing. But over time, particularly when the economy is healthy, debt is irresistible. When growth seems guaranteed, why not borrow more? Banks add to the dynamic, lowering their standards the longer booms last. If defaults are minimal, why not lend more? Mr Minsky's conclusion was unsettling: periods of stability breed financial fragility.

That is a powerful insight, but quite what to do with it is another matter. Over the years mathematics has become the language of economics. Mr Minsky's narrative approach left him outside the mainstream. Since 2008 academics have, with varying degrees of success, tried to bring more quantitative rigour to his instability hypothesis. They have shown how long stretches of low volatility and high debt-to-cashflow ratios are indeed predictors of trouble. For policymakers, the main takeaway from Mr Minsky is that constant vigilance is required, especially when the going is good. This helps to explain the enthusiasm for macro-prudential regulations in recent years: for instance, banks' capital requirements are now designed to tighten when they lend aggressively. But Mr Minsky might also have predicted that, as more time passes without a crisis, we grow more likely to forget his warnings.