

The Stories that Economists Tell: Mainstream, Hyman Minsky, and
Institutional Views of Consumer Behavior

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Abstract: The financial crisis of 2008 provided an informal test of mainstream and institutional views of consumer behavior. The test posed by the financial crisis assumes the form of a “story.” A successful story provides a reasonably coherent explanation of events, confirming our beliefs and justifying our policies. First, the paper examines the failure of mainstream economics to present a coherent story of consumer behavior. Ignoring the relevance of assumptions as advocated by Milton Friedman leads economists to hypostasize the model, filtering information central to the crisis. Second, Minsky’s discussion of consumer behavior and its effect on cash inflows to businesses represents an institutional explanation regarding why Keynes’ long-run vision did not occur. The third section expands on some of the themes addressed by Minsky found among the contributions of institutional economists, focusing on efforts to mold the institutions to increase cash inflows to corporations and protect those inflows.

Keywords: Consumer Theory, Dynamic Stochastic General Equilibrium, Financial Crises, Hyman Minsky, Institutional Economics

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The financial crisis of 2008 provided an informal test of mainstream and institutional views of consumer behavior. Mainstream views comprising the permanent-income and the rational-expectations hypotheses form the basis of the dynamic stochastic general equilibrium (DSGE) model, the model encapsulating the mainstream view of the macroeconomy. The individual consumer is sovereign, prescient, and rational. Consumers maximize utility intertemporally, smoothing out their consumption over time.

In contrast, the institutional view beginning with Veblen and subsequently restated by Wesley Mitchell, Hyman Minsky, Ron and Sandra Stanfield, David Hamilton, and others make several points. First, consumption is a social activity shaped by the underlying culture. This, in turn, implies that people's preferences are influenced by others, suggesting that preferences can be molded. Second, as Mitchell points out, households have different motivations from that of business. Businesses tend to have a single goal: maximizing returns; households have a variety of goals, the most important of which is mutual support. And third, while both households and business lack information, the more complete information of businesses, their greater acumen and single-minded purpose gives businesses an advantage, particularly involving complex transactions characteristic of transactions leading up to the financial crisis.¹

The test posed by the financial crisis assumes the form of a “story,” a mapping between the model and reality (See Watkins, 2010, Wilber and Harrison, 1978, Wisman and Rozansky, 1991). A successful story provides a reasonably coherent explanation of events, confirming our beliefs and justifying our policies. An unsuccessful story does not, poignantly illustrated by

¹ As Mitchel notes, “Ignorance of qualities, uncertainty of taste, lack of accounting, carelessness about prices—faults which would ruin a merchant—prevail in our housekeeping. Many of us scarcely know what becomes of our money; though well-schooled citizens of a Money Economy ought to plan for their outgoes no less carefully than for their incomes” (Mitchell, 1912, 269).

Queen Elizabeth's query: "why had nobody noticed that the credit crunch was on its way?" (Besley and Hennessy, 2009).

The paper proceeds as follows. First, the paper examines the failure of mainstream economics to present a coherent story of consumer behavior. The failure reveals problems: cognitive, conceptual, methodological, among others. The crisis forced some mainstream economists to recognize an inherent flaw in the methodology of positive economics. Ignoring the relevance of assumptions as advocated by Milton Friedman leads economists to hypostasize the model, treating the model as though it is real. Revising the assumptions, however, implies that consumers are cognitively impaired. Second, the paper examines Hyman Minsky's view of consumer behavior. Minsky's discussion of consumer behavior and its effect on cash inflows to businesses represents an institutional explanation regarding why Keynes' long-run vision failed to occur. The third section expands on some of the themes addressed by Minsky found among the contributions of institutional economists, focusing on efforts to mold the institutions to increased cash inflows to corporations and protect those inflows.

The Stories that Mainstream Economists Tell: The Rational, Prescient Consumer

As noted, the DSGE model encapsulates the mainstream vision of the macroeconomy. Change results from external shocks forcing individuals to rebalance their portfolios.

The presumed virtues of the DSGE model lie in its mathematical elegance. Ricardo Caballero (2010, 86) refers to the model as "an irresistible snake charmer," a device that "allows one to generate impulse responses that can be fully described in terms of seemingly scientific statements." The phrase "seemingly scientific statements" underscores the problems revealed by the crisis, problems that heterodox economists have long noted. Referring to heterodox economics as the periphery, Caballero concedes that the periphery has been more successful in

describing the macro economy than the core: “up to now the insight-building mode (both past and present) of the periphery of macroeconomics has proven to more useful than the macro-machine-building mode of the core to help our understanding of significant macroeconomic events” (2010, 88). His approach is that of “gradually bringing the insights of the periphery into the dynamic stochastic general equilibrium structure” (2010, 87). As Caballero concedes, “Rational expectations is a central ingredient of the current core; this assumption become increasingly untenable as we continue to add the realism of the periphery into the core” (2010, 91)

Although appreciating Caballero’s efforts to include a degree of realism, there is something disingenuous about the lack of references to the “periphery.” Lack of acknowledgements perpetuates the myth that heterodoxy is “inferior.” It is an invidious distinction. One wonders if students borrowing unreferenced ideas would fare as well from their mainstream professors.

A revealed-preference approach, obviously, reveals that mainstream economists prefer mathematical elegance to realism. Such preferences are often associated with the fallacy of misplaced concreteness. The fallacy results in ignoring relevant information, an observation which Caballero attributes to Fredrich Hayek in his critique of scientism. Caballero hopes to avoid the fallacy. Avoidance, however, raises methodological issues. Addressing the failure of the DSGE model implies economists must consider the “story,” which means, *contra* Friedman, that the underlying assumptions are important. C.A.E. Goodhart notes that mainstream theory assumed “the existence of representative agents, who never default.” Goodhart continues:

This makes all agents perfectly creditworthy. Over any horizon there is only one interest rate facing all agents, i.e. no risk premia. All transactions can be

undertaken in capital markets; there is no role for banks. Since all IOUs are perfectly creditworthy, there is no need for money. There are no credit constraints (everyone is angelic, there is no fraud, and this is supposed to be properly micro-founded!). Money is generally introduced into the model by auxiliary ad hoc frictions, e.g. cash in advance requirements or limited participation, both of which are totally internally inconsistent with a world without any default. Essentially, therefore, the consensus three-equation model assumes a non-monetary, non-banking, system, so it is no surprise that most theoretical adherents of it tend to downplay attention to, or concern with, purely monetary variables, e.g. the monetary aggregates (2009, 826).

Minsky's Institutional Story of the Failure of Keynes Vision

Since the financial crisis, Hyman Minsky's financial-instability hypothesis has become widely used to explain the crisis. Over time, businesses seek riskier investments such that cash inflows (total revenue less variable costs) are insufficient to pay the interest payments on debts. The refusal of creditors to refinance forces businesses to sell assets, potentially precipitating a debt-deflation depression. In the crisis of 2008, the decline in cash inflows stemmed from consumers' failure to make their mortgage payments, which prompted renewed efforts to understand consumer behavior.

Years before, Minsky already sought to form a more realistic view of consumer behavior to explain why Keynes' long-run vision failed to occur. From an institutional perspective, Keynes viewed depressions as manifestations of the conflict between the rentier and entrepreneurs over the surplus generated by capital. As Keynes asserted, the Great Depression represented a situation where the marginal efficiency of capital fell below the rate of interest.

Capital yields a return not because its productive, but because its scarce, and it is kept scarce by a policy of high interest rates set by the rentier. Displaying an aversion to revolution, Keynes long-run solution to the problem of depression lay in euthanizing the rentier by allowing the marginal efficiency of capital to fall to zero (Keynes, [1936] 1964).

Keynes believed that British society was on the cusp of the satiation of wants. “Keynes held that once the twin evils of abject grinding poverty and war were banished from the earth, not much more in the way of worldly goods than was within sight would be needed to achieve true affluence” (Minsky, 1975, 152).

Why didn't this occur? Minsky offers several reasons. First, “the rich turned to consuming capital-intensive bundles of goods rather than philosophy and culture and that their example became generalized, and this conspicuous consumption has led to a continuing capital shortage” (Minsky, 1975, 153). Second, Keynes believed that societies such as the United States and Western Europe could satisfy the primary needs of individuals, leading to a decline in the return to capital. Minsky attributed the high return to capital to the growth of relative needs, needs stemming not from self-preservation, but from conspicuous consumption. Third, inequality in the distribution of income has further maintained a higher return to capital. “It is the income distribution associated with capital scarcity that may have set the consumption pattern that has led to a continuing capital shortage. In order to achieve the euthanasia of the rentier, it may be necessary to first achieve the income distribution that Keynes argued would exist after the euthanasia was achieved” (Minsky, 1975, 153). Fourth, consumers preferences have been molded, recalling Galbraith's dependence effect. “[T]he direction taken by the growing relative needs is inspired by and largely the product of “education” in the guise of advertising. In our current system, affluence has not brought a demand for the quiet pleasures; but rather has been

associated with proliferation of demands for goods that require capital assets” (Minsky, 1975, 153-54). And fifth, Minsky suggests that the dismantling of government programs enacted prior to WWII to provide employment along with subsidies to capital in the form of weapons contracts have maintained the return to capital. Minsky offers the following conclusion: “It might well be that the euthanasia of the rentier in the form that Keynes envisaged it requires prior constraints on the growth of relative needs, and the constrained growth of relative needs requires an income distribution based on low or no income from capital ownership, i.e., the prior euthanasia of the rentier” (Minsky, 1975, 154).

Mainstream economists, of course, would respond to Minsky arguing that human wants are insatiable. If so, nature has condemned humankind to a life of frustration in the search for happiness. Humankind is like Sisyphus, condemned forever to roll the rock to the mountain top only to have it roll back. The elusiveness of happiness points to the paradox of affluence, “the deterioration in quality of life despite or because of sustained growth in consumption” (Stanfield and Stanfield, 1980, 437). In response to the idea that wants are insatiable, David Hamilton reminds us that “wants are not made in heaven” (Hamilton, 1987, 1537).

William Redmond rephrases the question. “Suppose that incomes continued to rise indefinitely. Would we spend the whole packet on more consumer goods, or is there some point at which enough is enough?” (Redmond, 2001, 575). Redmond answers no, but not because wants are naturally insatiable. In Redmond’s view, “wants and preferences are not innate but rather are shaped by institutional forces. For the present purposes, it means that material desire can inflate to match the possessions, and thus the apparent desires, of others. Erstwhile stability of preferences is subverted by social exposure, as the consumer who sees more wants more”

(2001, 580). The consumer is not “*homo economicus* but *homo emptor*, the acquisitive actor of the consumer culture” (2001, 585).

Molding Consumer Behavior to Increase and Protect Cash Inflows

Many of the themes mentioned by Minsky have been addressed by institutional economists. From the corporate point of view, the purpose is to engage in institutional change to mold consumer behavior to increase cash inflows.

For some years, corporations sought to move people from declaring chapter 7 bankruptcy to declaring chapter 13 (Waller, 2001) . In 2005, Congress passed *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, making it more difficult for people to declare bankruptcy. (Scott, 2007, 493). The Act of 2005 strengthened Chapter 13 as an alternative. Chapter 7 allowed people to eliminate high-interest, unsecured debt. Mortgage debt, student loans, loans for medical procedures were not eliminated. Chapter 13 offered debtors the opportunity to reorganize their debts, extending the payout period. Credit card companies donated approximately \$25 million between 1999 and 2005 to lobby Congress to reform the bankruptcy laws. The estimated return to credit card companies from their lobbying efforts is estimated at \$4 billion (Scott, 2007, 495).

The relationship between rising inequality and rising debt levels have been an ongoing theme among institutional economists. Timothy Wunder (2012) noted that the rise in income inequality create macroeconomic instability. Inequality encourages consumers to incur debt, which increasingly drives the business cycle. Inequality has also contributed to creating a new class of poverty, the debt poor. The debt poor refer to households technically above the poverty line but because of debt service they live below the poverty level (Pressman and Scott, 2009,

425). Furthermore, the low savings rate are also thought to stem from rising inequality (Wisman, 2009).

Christian Weller attributed the rise in consumer debt not so much to relative needs, but primary needs. “The data suggest that the run-up in debt is more a consequence of economic necessities than of profligate spending” (Weller, 2007, 584). Incomes stagnated while the costs of healthcare, transportation, food and so on increased. Moreover, many households got caught in the housing boom.

Holt and Greenwood (2012) note that the increased inequality in recent years also created three negative trickledowns. First, beginning in the 1980s, the least expensive homes incurred the largest appreciation. Instead, builders chose to concentrate on the upper-end of the market since rising incomes accruing to those in the upper brackets made large homes more profitable. Second, the rise in income at the top, easy credit, and the prospect of windfalls from flipping houses escalated pecuniary emulation. Third, increases in inequality led to a declining middle class, isolating lower income families. The rise in inequality further led to a greater disparity in local public goods such as educational opportunities.

The government’s response to the crisis continues to protect corporations. David Zalewski notes the unfairness of bailing out the banks while doing little for homeowners. In response, Zalewski advocates “combining an employer-of-last-resort (ELR) program with one in which the federal government acts as a [Lender of Last Resort] LOLR to distressed homeowners” (Zalewski, 2011, 374).

Conclusion

A brief, albeit incomplete review of the institutional literature in recent years leads to an obvious conclusion: the system is rigged. Mainstream economists have made a half-hearted effort to make their models more realistic, emulating heterodox approaches. A full-hearted effort, however, would follow Minsky in addressing efforts of corporations to increase their cash inflows. In that case, the mainstream would fully emulate institutional economists in their endeavor to understand and improve the economic process. Perhaps it will take the next crisis.

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