Philequity Corner (September 29, 2008)
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Black Swans and Minsky Moments

Investors worldwide are still puzzled about the financial turbulence. Stock markets around the world are falling and investors are suffering from unprecedented losses. The credit markets are frozen and the money market in the United States almost collapsed. How can the most sophisticated financial market in the world be in such turmoil? How can the most revered investment banks like Bear Stearns and Lehman Brothers enter bankruptcy? Over the weekend, we just witnessed the biggest banking collapse in the United States. How can the biggest savings bank in the United States which is more than a hundred years old like Washington Mutual collapse?

Trying to understand these events in these tumultuous times lead us to two theories that may explain what is happening. THE BLACK SWAN AND THE MINSKY MOMENT.

The Black Swan theory

The Black Swan theory is defined as a large-impact, unpredictable, and rare incident beyond the realm of normal expectations. This concept is commonly used as a metaphor for something that could not possibly exist. As what we are all accustomed to, all swans are white. Nassim Taleb made the concept popular in his best-selling book *The Black Swan: The Impact of the Highly Improbable*. In his book, he claims that almost all consequential events in history come from the unexpected. He cited events like the World War I and the 9/11 attacks as examples of the Black Swan concept.

In the world of finance and investments, the Black Swan theory could be applied to some well-known events. Notable examples of which are the Wall Street Crash of 1929 (commonly known as Black Tuesday) which eventually led to the Great Depression and the Asian Financial Crisis of 1997 which all started with the sudden collapse of the Thai baht causing the devaluation of most Asian currencies, including the Philippine peso.

More recently, the US Subprime Crisis was another unexpected occurrence. This event gave rise to the string of failures among Wall Street's biggest investment banks. Considered by many as the biggest market downturn since the Great Depression, the collapse of the three Wall Street heavyweights – Bear Stearns, Lehman Brothers, and Merrill Lynch – was unthinkable and beyond expectation. Equally surprising was the failure of AIG, the largest insurer in the US. The failures of state mortgagors Fannie Mae and Freddie Mac threatened the stability of the economy. Federal Deposit Insurance Corporation's (FDIC; equivalent to our PDIC) seizure of Washington Mutual made a big statement on the financial capability of the entire banking industry. Slowly, the picture of a dysfunctional financial system unravels.

The Minsky Moment

Minsky Moment is named after economist Hyman Minsky, PhD. Considered as a radical economist, Dr. Minsky's theory is that financial systems are inherently unstable. His main contribution to economics was a model of asset bubbles driven by credit cycles, the peak of which is fueled by speculations that end in a tumultuous crisis. Dr. Minsky noted that investors take on risks when times are good, but the longer times are good, the more risks these investors take, until they absorb too much risk. A point is reached where assets are no longer sufficient to pay for the debts that have been accumulated to pay for the speculative investments. Eventually, this leads to a collapse of asset values.

By this explanation alone, the US Subprime Crisis fits the model of a Minsky Moment. The feverish speculation in the property sector was an example of wanton greed. People and financial houses were taking speculative risks with reckless abandon. With uncontrolled risk appetite, lenders sought higher returns and opened the lines to less creditworthy homebuyers (hence the term subprime). When the property market slowed down, amortizations were slowly unmet which yielded to increasing default risks. Undercapitalized banks, in turn, experienced a slow death, as they were unable to collect. A downward spiral has commenced. The series of bank failures (and closures) we are witnessing in the headlines are all anecdotes of this phenomenon.

Dr. Minsky wrote that "a fundamental characteristic of the US economy is that the financial system swings between robustness and fragility, and these swings are an integral part of the process that generates business cycles." As the financial system appears to tread the "fragility" side of the business cycle, uncertainty persists which eventually leads to a financial crisis.

Day of Reckoning

If one believes in the theories of the Black Swan and the Minsky Moment, then the collapse of banking institutions and the failure of the financial system are inevitable. The day of reckoning has arrived. As Greenspan stated, the events unfolding happen once in a century (see our Philequity Corner article in Philstar last September 22). The failures of Fannie Mae, Freddie Mac, AIG, Bear Stearns, Lehman Brothers, and Washington Mutual were disasters waiting to happen. There was no escape.

During good times, Hyman Minsky's and Nassim Taleb's theories are ignored. It is only during financial crises when they are remembered and their models discussed and analyzed. Their works undeniably reflect the current landscape in the United States. We have just seen a *Black Swan* and experienced a *Minsky Moment*.

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