Abstract

At its core, Financial Instability Hypothesis is a theory of cyclical booms and busts due to the accumulation of private debt, where each expansion carries the conditions for the next regression and the latter sets the conditions for future growth. That is, “stability is destabilising”. The purpose of this paper is to examine how financial fragility is linked with the trade performance of a country and with the cross-country differences in industrial structure. The intuition is simple. A weak international trade performance is more likely to amplify financial instability due to lower multipliers and therefore insufficient cash flows and profits compared to a closed economy. Moreover, it is more likely to create a banking sector prone to liquidity and solvency pressures due to a continuous transfer of reserves to the surplus country. On the other hand, a country with a strong international trade performance is more likely to experience a paradox of debt, where the debt ratios do not increase as much due to income streams from abroad and to have a banking sector that is financially healthier and more capable of providing credit on demand. In a flow-flow consistent framework, this implies that the coexistence of a severe financial crisis in one country and a paradox of debt in another are two sides of the same coin; the same Minskyan mechanism of FIH is softened in the exporting country and amplified in the importing country through two distinct channels. We develop a macrodynamic model that focuses on the effects of international trade and the European interbank market on domestic investment and financing decisions. The key features of the model follow below.

First, the model consists of two European countries, each one with four sectors: households, firms, banks, domestic central bank. This allows for a detailed examination of the channels that connect each sector and also for an institutionally specific analysis of international economic relations. Exports are assumed to depend on both price and non price factors, which reflect the underlying industrial structure of each country. Second, it is assumed that banks actively try to satisfy the requirements informed by Basel 3. Banks lend to firms according to their perception of risk and make decisions regarding their liquidity, capital adequacy and leverage ratios. Third, the model has an explicit interbank market and a Target2. This payment system is responsible for the allocation of ECB reserves and the settlement of payments. In order to capture financial fragility, the model takes into account total corporate debt and banks’ financial health. There are two channels through which financial fragility is transmitted in an open economy setting. A weak industrial structure results in lower propensities to export and productivity growth rates. The first channel operates through effective demand and income multipliers. A weak export performance and a negative trade balance leads to lower income multipliers and therefore to lower income streams. Lower income streams result in a lower mass of profits and a higher demand for loans. This tends to increase firms’ leverage ratio and therefore credit rationing. This increases financial fragility. The second channel operates through the financing conditions and the provision of credit. A weak exports performance leads to income and reserves transfers to the foreign economy. This occurs due to negative exports but also due to bonds’ interest payments. This, tends to decrease banks’ capital adequacy ratio and to decrease banks’ liquidity ratio. The first order effect is a negative effect to investment due to credit rationing. The second order effect is an increase in interbank lending rates, which reduces banks’ own funds and therefore leads to more credit rationing and an increase in financial fragility.
Financial Instability Hypothesis, developed by Hyman Minsky, is a theory of cyclical booms and busts due to the accumulation of private debt, where each expansion carries the conditions for the next regression and the latter sets the conditions for future growth. Stability is destabilising!

First Channel
The first channel operates through effective demand. A weak industrial structure results in lower propensities to export and productivity growth rates. Investment in non-tradable sectors makes things worse as it does not create spillover effects. A weak export performance and a current account deficit leads to lower income multipliers. Lower income results in a lower mass of profits and a higher demand for loans. This tends to increase firms’ leverage ratio and therefore credit rationing. This increases financial fragility.

Second Channel
The second channel operates through the financing conditions. Current account deficits lead to income and reserves transfers to the foreign economy. This, decreases banks’ capital adequacy ratio and liquidity. The first order effect is a negative effect on investment due to credit rationing. The second order effect is an increase in interbank lending rates, which reduces banks’ own funds and therefore leads to more credit rationing and financial fragility.

Further Research
We intend to use both estimations and calibrations in order to fit the model to data for two European regions. Simulations will be held in order to demonstrate the links between the:
- current account imbalances and industrial structure
- industrial structure and financing conditions
- financing conditions and financial fragility

Main References