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J.A. Kregel

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Margins of Safety and Weight of the Argument in Generating Financial Fragility

J.A. Kregel

No one who has heard Hy Minsky describe the negotiations between a bank loan officer and a potential business borrower will ever forget it. The dissection of the *pro forma* statement of prospective cash receipts and commitments for the proposed investment project is the focal point of the process that determines the acceptable margins of safety for both the borrower and the lender. And the idea of financial fragility is built around changes in these margins of safety.[1] It is the slow and imperceptible erosion of these margins of safety that produces financial fragility. When margins have been reduced to the minimum, even the smallest departure of realizations from expectations creates conditions in which firms have to deviate from their planned actions in order to meet fixed cash flow commitments. This can mean delayed payment or distress borrowing. If this is unsuccessful, investment plans may be delayed, and distress sales of inventory or of productive assets may be necessary. The result is a Fisherian debt-deflation process, which produces falling prices, rising real debt burdens, and the reversal of the normal laws of supply and demand. Lower prices increase supply and reduce demand.

Minsky's main contribution to the description of these events was to point out that they were inevitable. He formulated them as an endogenous process in which sustained economic stability produced financial fragility. It has become common to describe this process of endogenous creation of financial fragility as one of mutual contagion in which the entrepreneur's optimism, reinforced by his past record of success, eventually overcomes the natural scepticism embodied in the banker's query "How are you going to repay the loan?" Thus, as tranquil conditions turn to

The author is Professor of Political Economy, University of Bologna, Italy. This paper was presented at the annual meeting of the Association for Evolutionary Economics, New Orleans, Louisiana, January 4-6, 1997.

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