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Finance and Economic Breakdown: Modeling Minsky's "Financial Instability Hypothesis"

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Finance and economic breakdown: modeling Minsky's "financial instability hypothesis"

From as long ago as 1957, Minsky has argued that an advanced capitalist economy with developed financial institutions is fundamentally unstable, and liable to fall into a depression in the aftermath of a period of debt-financed "euphoria." His strictures were comfortably neglected during the long boom of the 1960s, and even during the oil and Third World debt shocks of the 1970s. However, this hypothesis cannot be ignored after the long period of economic instability ushered in by the crash of 1987. The late 1980s were manifestly a period of euphoria, financial innovation supported the boom, and the desire of both corporations and banks to recover from excessive debt is, to lay observers at least, a major factor in the "jobless recovery" of the early 1990s. Clearly, current economic circumstances warrant a more considered evaluation of Minsky's theories.

This paper models four basic insights of the "financial instability hypothesis" on the foundation of Goodwin's limit cycle model: the tendency of capitalists to incur debt on the basis of euphoric expectations; the importance of long-term debt; the destabilizing impact of income inequality; and the stabilizing effect of government. The introduction of these concepts into Goodwin's framework converts his stable but cyclical system into a chaotic one, with the possibility of a divergent breakdown—the simulation equivalent of a depression.

Keynesian foundations

Minsky's financial instability hypothesis derives from his distinctive reading of Keynes, which is based largely on chapter 17 of *The General*

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