Sources of Financial Fragility:
Financial Factors in the Economics of Capitalism.

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"...one of the finest problems in legislation, namely to
determine what the State ought to take upon itself to direct by the
public wisdom, and what it ought to leave, with as little
interference as possible, to individual exertion"

Edmund Burke, as cited in Keynes who in turn cites
McCulloch's Principles of Political Economy.

"If the Good Lord didn't want them to be sheared, He
would not have brought forth so many sheep"

Memory of a newspaper citation of a comment in
regard to losses at Lloyd's of London and the "Taking of
the Names"

Paper prepared for a conference: Coping with Financial
Fragility, A Global Perspective. Maasdrecht, September 7
The main emphasis of the paper is on unemployment as a flux phenomenon: i.e. unemployment appears when the system changes. Even though Keynes considered an unemployment equilibrium, we hold that unemployment would not exist if the system were in a tranquil state.

[I DO NOT UNDERSTAND WHY YOU HOLD THAT UNEMPLOYMENT WOULD NOT EXIST IN A]

"TRANQUIL STATE" IF IT WAS A STATE COMBINING AN OVERALL ROBUSTNESS OF MARKETS WITH INNOVATION AND TECHNICAL CHANGE. IN SUCH AN ECONOMY THERE WOULD ALWAYS BE SOME MINIMUM OF UNEMPLOYMENT DUE TO THE PROCESS OF INDIVIDUAL FIRMS DYING EVEN AS OTHERS ARE BORN — A PROCESS MARSHALL MADE MUCH OF. HPM]

Unemployment is a function of change. It must be
IV. Interrelated Balance Sheets as a Way of Understanding Capitalism

The alternative to beginning theorizing about economies by positing utility functions over the reals and production functions with something labeled K (called capital) is to begin with the balance sheets of the various agents. Within a closed economy every financial liability of a unit shows up on another balance sheet as an asset. The basic structure of a capitalist economy is given by the interlocking balance sheets and associated income statements of the units in the economy.

The units can be conveniently grouped into sets, business, household, financial institutions and government. Every liability is a commitment to pay some form of money, as stated in the contract which sets up the liability (or asset). A liability is a commitment to make payments on principle and on interest either
1. along a time axis as stated in the contract.
2. on demand.
3. upon the occurrence of specified contingencies.

The third, contingent payments is of importance in the transformation of a liquidity crisis into a solvency crisis, because long term debt becomes demand debt when any short term default happens.

The liability side of the balance sheet of a unit at any date can be read as a time series of payment commitments from now until the maturity of the longest term debt on the balance sheet at that time: this time series changes as new liabilities are added and old liabilities mature. This time series is the prior commitment of future gross receipts at the specific date.

In this view of a balance sheet, equity liabilities (common stock) are special because these instruments
Aggregated the larger equity financing the more robust the financial system.

When the term structure of interest rates is normal the interest rates on short term loans are lower than on long term loans. The units with imperfect foresight believe they have better information about the short term prospects of the borrowers than of the long term prospects. Units which have normal relations with bankers for short term financing find it feasible to introduce some longer term financing into their liability structures. Bankers as merchants of debt are all too willing to teach customers with whom they have profitable relations how to use short term debt. The middle men of the commercial paper markets also find it profitable to teach their customers to use some short term debt for long term financing. The customers find the use of short term debt profitable: it is an easy way to add to their bottom line. Furthermore the ability to tap such sources of credit is viewed by the lenders as a sign of their market power.

Even in the absence of the use of short funds for long term purposes the continued operation of a firm requires that short term credits be refinanced: the short maturity leads to the need to finance the principle amount.

By the very nature of their demand liabilities banks are organizations which need to roll over their debts. Typically new deposits as well as the flow of cash due to their own assets performing offsets the major part of their losses through the clearings. However banks keep secondary reserve assets, which they can sell in broad markets, to offset such transitory reserve drains.

The emergence of short term financing, which
organizations, whose incomes are independent of changes in short term interest rates, a rise in market interest rates, which affects the rates that have to be paid when debts are rolled over, can lead to total interest costs exceeding the income available to pay such debts. Then by not spending accruing funds to maintain capital assets or by borrowing to cover such payments, the firm runs down its equity base: it increases its debt to equity ratio. This type of financing which capitalizes interest due and paid is called Ponzi financing. Its practice leads to rising debt to equity ratios and a smaller coverage of debt financing costs by income.

Note that if an organization practices Ponzi financing long enough the equity base of the organization will disappear. Unless transitory Ponzi financing leads to bankruptcy.

Liquidity has two dimensions: one is the flow dimension which takes the form of
1. gross capital income for businesses. i.e. cash flows
2. gross wages, transfer payment receipts and financial asset income for households
3. tax receipts for government

As a result of a dated largely reflects wage income flows (as well as transfer payments, and incomes from wealth as well as the standard form of the ability to transform an asset into money which gives the Keynes "attribute of assets" as its income stream, carrying costs, and ability to transform into money by sale or a put to the issuer.
disturbed that it will not bounce back to its original (apparent) form.

A dead or dry branch on a tree will break off with relatively little effort and it will not return to its original form.

We live in an economy in which institutions have been erected to contain the repercussions of fragility.

One way to understand the American fragmented and compartmentalized financial system is to recognize that the structure was laid down in the immediate aftermath of the great depression and the effort was to develop a structure of financial institutions which would prevent a debacle such as that of 1929-1933 from ever occurring again;

A resilient Economy can crash can start the process of a debt deflation but it is contained. In the modern capitalist economies the containment often involves government refinancing of serious players-

The bail out in the United States
A solvency crisis: The net worth of the institutions fell towards and below Zero. The intervention in principle let the value of the equity in the institutions go towards Zero: In principle there was no bail out of the equity owners.

V. Profits

In a capitalist economy Profits, henceforth PR are determined by the composition of aggregate demand. Capital assets are not valuable because they are productive, they are valuable because aggregate demand and its direction makes them scarce.
In a paper titled *The General Theory of Employment, Interest, and Money* published recently, we read a version of the famous equation:

\[ I_t = \frac{P_t T}{P_t} + b (I \text{r external Funds}) \]

\[ I \text{t external Funds} = P_t R_t - \Delta \Delta \text{Debt}_t \]

\[ \text{Debt}_t = I_r - I_t \text{r internal Funds} + \Delta \Delta \text{Debt}_t(t-1) \]

As well as some discussion of the model with a mixed view of the instant coefficients as external funds.

This model does not lend itself to an analytical solution but has several significant implications. The equation almost a from hatted cycle.

1. Debt falling, real profit rising
2. Profit rising, debt rising
3. Debt rising, profit falling
4. Debt falling, real profit falling

Note: By putting a plan in profit stable is the great debt we made it impossible for the ability to fell into a "black hole" in which to arise because of an opening in a profit fall to zero.
disturbed that it will not bounce back to its original (apparent) form.

a dead or dry branch on a tree will break off with relatively little effort and it will not return to its original form.

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Introduction:

Implicit in the conference's titles, "Coping with Financial Fragility: A Global Perspective," implies that financial fragility is a meaningful concern. Its existence as a state of nature is accepted. However, it is not for me to measure that it exists throughout.

This lesson is not mine. Financial fragility is a concern for my colleagues. In his lesson, Professor Benston, Kugler, Calomiris, and Edwards, deal with specific sources in the banking and financial systems. The macro economy and securities and derivatives, and of these, has been assigned to talk about financial fragility in general.

This assignment is just.

For many years, now, it has been arguing that:

1. Meaningful economic policy for a modern capitalist economy cannot be constructed by first...
relative to long-term and equity financing.

4. As a result of the growing debt relative to
income and short-term debt relative to long-term debt and
the equity component on the receiving side, firms become
dependent upon the month-to-month fluctuation of financial markets in
which debt can be reflected or floated.

5. These highly financial market developments encourage
a change in the way investment and position in the
stock of capital assets are financed:

6. As a highly leveraged economy the primary
consideration as well as capital assets organized in the
production unit with market power become sensitive
to the terms upon which financing is available.

7. I through 6 mean that an interactive process
in which investment, profit, asset prices, employment

6. In a more Keynesian view, this sequence was called a
debt-deflation by Irving Fisher.

8. The effect of a debt-deflation, if it is allowed
a free reign, can be a deep and even a depressant
profound downturn.

In writing of a debt-deflation Irving Fisher described
the process from an initial position of overindebtedness. Then
argued that monetary tightening by the Federal Reserve
should "interest rate differentials" which made financial
market instruments potentially more profitable. For businesses
as these potentially profitable financial choices - I believe I
used the term emerging Federal Funds Market as an example -
which their way through the economy (by increased the
amount of financing and small quantities of reserves early
support.  

Gee Velocity increasing in this change

in part that Federal Reserve efforts to constrain an
volume as occurred by shrinking of bank assets and "money supply"

The second I argued should be first.

Schumpeter in followers would be excited by the innovation
and more for a time. This concrete available financing would
be virtually infinitely elastic.

I made direct argument by noting that Central

 Banks can be very close to the meaning of financial

institutions since Central bankers in given to

having a "broad" line perspective on the significance

of their operations.

When we CIO was hunting "for people to

undertake projects they received of how interested in
The basic problem that I start with is staying with Aaron Fisher's Debt Deflation Theory from Deep Depression. The key argument begins with an initial position of an "initial" condition of overindebtedness. This initial position had to come from somewhere. An example is a "shock" in displacement not from a debt-deflationary condition. If overindebtedness existed, then a similar shock would not have much effect if overindebtedness did not exist. Both overindebtedness as well as the initiating "shock" in displacement should be economic stimuli, not events that are endogenously determined. The focus is on inquiry shifts to the route capitalist economy as an internally led, if not self-stabilizing, economic system. For those concerned with economic theory, the integrated "real and financial" process is an interpretation of Fisher's
and the need of cash flow from maize production to
validate debts has other concerns than the more
demonstrative that an equilibrium exists.
Determinants

Financing Structure: The Structure of Income Flows

In taking up the financing relationship of income flows, we begin with business debts and profits flows. The "economy" consists of sets of units, businesses, households, financial institutions, governments, and the rest of the world. These form a few under structure or interrelated indebtedness, and refer to financial resources. Financial Deregulation.


Every element in these sets has a balance sheet and income statements. The connection we first emphasise is that between income flows, income flows, profits, and the business payment on debts and repays. The underlying framework is in increment.

M. K. Kolesnik
Financial Institutions, Economic Policy and the
Dynamic Behavior of the Economy, a paper
by Dominico Belli Gatti, Maurizio Gallegati ad
I prepared for the International Joseph A
Schumpeter Society Fifth Conference at
Münster Germany August 17-20 1994. These are

1. \( I_t = a V_t + b(I_F)_t \)
2. \( I_F = P_{R} - r_{t-1} D_{t-1} \)
3. \( D_t = D_{t-1} + \Pi_{t-1} - I_{F_{t-1}} = D_{t-1} + F_t \)
4. \( r_t = \frac{F_t}{n_{o+t}} \)
5. \( F_t = I_t - I_{F_t} \)
6. \( b_t = b_0 + b_1 \arctg P_{R_t} \)

We are essentially interested
in just a convenient function from which it gives us

\[
\frac{db}{dP_R} > 0 \quad \text{and} \quad \frac{db}{dP_R} < 0
\]

\(2^\pi\)
The results of simulations of reduced fear are gratifying to those who have long argued for progress and for increased equity and debt financing of investment. In most cases, a nice dampened progression to an equilibrium. Depending on the critical value of the \( b \) parameter, the system may exhibit damped oscillatory behavior or an equilibrium at large \( b \) values. Large \( b \) values lead to cyclical or non-cyclical explosive cycles. For values of \( b \) which are neither small nor large, the time series for \( P_t \), \( D_t \), and \( B_t \) may exhibit the hysteretic and chaotic behavior that we have seen. Therefore, we have equilibrium, turbulent, and chaotic behavior, depending on the parameters.

One interesting feature is that some simulations exhibit a four-phase Debt, Profit, Behavior, which is profit increases relative to debt as debt falls, while profits are increasing:

1. Profit and debt both rising
2. Profit and debt both falling
When the productive investment without debt is a source of profits.

In our modern economies, government outlays account for a large portion of the economy. The Social Security recipients—just like the worker who produces investment goods—are this spending. Any increase in government tax and spending functions are cyclically sensitive. At one point, fiscal policy was even considered as the economy’s steering wheel so that deficits increased in recessions and decreased in booms.

A point about the U.S. and other

Treasury spending to prevent a pass through of the losses in say S&L assets to depositors in S&L’s. Such refinancing does not directly show up as financing spending on goods and services. On the other hand, we would not now be contemplating a fairly prosperous America if the bankruptcy of Fannie and Freddie...
In order to maintain a stable macroeconomic environment, the interest rate on movements in the market must be in line with the debt movements. The interest rate on the cash flow becomes an important factor in the context of profit distribution. The assumption of profits by debt servicing reduces and even eliminates the endogenous financing of investment. Therefore, the resilience of the fragility of a financial structure depends upon the behavior of indebtedness and the behavior of profit flows. In an economy in which \( \frac{\Delta F}{\Delta t} + b \frac{F}{t} \) is the total annual determination of profit flows, then a collapse of investment due to the elimination of internal funds and the likely fall of \( b \) as the margin of safety of profit becomes the debt servicing variable \( b \) will bring investment to a halt and lead to a collapse of profit flows.

The recovery in such an economy comes after two primary attributes of a bankrupt economy are taken into account. Not all firms become highly indebted, but measures taken by banks to avoid bankruptcy leads to increasing access to debt repayments. Then the
This shows how the Federal Reserve was shown to be not able to deal with a solvency crisis in the banking system in 1933. So in 1938, it was shown that the Federal Reserve cannot handle a solvency crisis. In 1933, the Treasury through the RFC refinanced banks. And in 1938, the Treasury once again had to refinance many commercial banks and thrift institutions so that no loss would take place.
The upside is the government's ability to...

The new Paul Stratum... Computer Malicious... attack...

Stratum's attack: Transfers & Examin... Market 'land organized:

...trust

In return for publicly

publishing trust:

Security Analyses...
The investment function is taken to be a linear function of the real rate \( r \) and \( \bar{b}(I_F) \) as \( y \) assumed.

2) \[ T = a(r) + b(I_F) \]

3) \[ I_F = \frac{\bar{b}_{-1}}{\bar{b}_{-1}} - \bar{b}_{-1} D_{b-1} \]

4) \[ D_{b-1} = D_{b-1} + I_F_{b-1} \]

5)
As Fisher begins his exposition to the
interaction between financial and real manu
for a frictional positive overindebtedness.
Certainly in the post-Great Depression era by the early 1930's was characterized as a
persistently increasing indebtedness. The Great
Depression, books reviewing the Great Depression
especially noted in G.S. Hunt's "Debts and
Recovery: A Study of National Debt of the United States"
and in Marder & Deaton's "Overindebtedness: A
Study of the United States" noted variables that led to the
Great Depression. If I recall correctly, one

overindebtedness was

since debt was increased by 1935, it is
certain that debt increased monstrously between
1929 and 1933, instigating the great
effort to reduce debt. This was to become the
dominant in the bond ratio - yields (to
take this which was very light by current standards)
10% in 1935 years.
The meaning of profit by surmise

The meaning of profit by surmise

deficits → employment did not fall = le

they might

The idea: The surmise deficit spending

is a problem because it helps sustain output

when the private sector falls in output

and in a worse economy with no surmise

no foreign trade, then really is the same

as standing in goods and no profit motive

$\text{C}_E = \text{W}_c + \text{W}_I + \text{W}_G$

$\text{C}_A = \text{W}_c + \Pi_I$

$\text{C}_A \times \text{L} = \Pi_I \times \text{W}$

$\text{L}_C + \text{L}_I \times \Pi_I \times \text{W}_{\Pi}$

$\text{I}_I = \Pi_I \times \text{W}_{\Pi}$

\[ \text{I}_I = \text{I} + \text{W}_{\Pi} \]

\[ \text{C}_I = \text{W}_c + \text{W}_g + \text{C} \]
Big Government where the fragility would be
due to a virtual collapse of the existing system,
like by process by discretionary stabilization

Need to protect the ability to have
sufficient to issue debt at a high level in
some “liquidity + safety” are private debt
effect protective against chronic deficit and
an error by systematic risk.

A robust financial structure requires a
government that is not a monopoly on the
deficit, how it is nurses.
The current situation,

The deficit in the currency
The assumption that even if there
true wealth ratio is strong
expressible in notes. How similar
be taken that ability to raise revenue is ensuring

The current situation,
IV. Compartmentalization and Transparency

From March 1933 until the middle of 1934, our national economy, the 1929-33 depression as business existed, as we went "backwards" from 1929 to 1933 - a comparable time. We not only incurred the great contraction of 1929-33, but also the fallout when the Great Wall so-called "reopened" and the Kregge-Boomer crisis of 1907. The crisis of 1907 was serious enough to form solidified opinion to the effect that the system of the National Banking Act had to go and a centralized Banking Reserve had to be created. The First Federal Reserve System failed to contain the great contraction of 1929-33. A second Federal Reserve System was created. The monetary policy of the National Banking Act that had a 100-year substantially lenient time the 20 years from 1933 created its regulatory difficulty, but the earlier Federal Reserve System hit the wall as early as 1935. It would be too much to assume that the examination, development, in the National Banking Act has not been in the regime of that act that the 1929-33 depression as business existed. The self-interest between National Banks, organized as corporations, and investment banks, organized as partnerships, in attracting the large popular investment has become a matter for the future.
The reform of the American Banking System after the collapse of 1933 followed two principles: compartmentalization and transparency. Compartmentalization was designed to "break" banking into a set of specialized institutions. The new institutions were not only more efficient but also would be narrowly defined so that they would be understood by examiners and supervisors. New banks, industrial, agricultural, and rural credit institutions and a new bank for small business were both specialized institutions with specialized duties performed by different institutions.

Financial institutions were supported and backed by a government investment bank. The Reconstruction Finance Corporation.

Aside from strengthening banks, the 1930s saw the creation of the Securities and Exchange Act and the creation of the Securities and Exchange Commission. We must recall that the great depression in the 1930s led to unemployment of 25%.
great dilemma much in the way of revelation of self-serving in the totally enmeshed managers and reformers perpetuated by market operations was reversed. Major King, Stock Exchange Officials and "the geniuses" of the Electric Power Industry were still the stuff of the daily press.

There was a need for a body of law and administrative oversight that would make it clear that stock and bond holders would not be plundered in the same manner as earlier, if the flow of funds through the exchanges and the corporate financial corporate investment was to remain. Transparency in the exchanges and the channels of investment became the only device that was used to "structure" security laws.

Both compartmentalization and transparency may well be under siege today. The first was due to the globalization of financial markets in part but to how the new players - the new structures of financial markets. In part the new structures is due to sophisticated technology which has done away with "shares" and made it possible to compute that which could not be bought or
a small government, loosely integrated system in which
large financial houses investment banking firms - Morgan,
Kuhn, Loeb, et al. This century an interlocking web of
compensation tied to a considerable extent called the "Ike
for free economists. Because the decline in actual
value of gold, and because of Depression and World War II, financing
the end of World War II saw United
States capital out of debt, as in fact they were large
holders of government debt. 
Commercial Banks, as
well as the Savings Banks (the thrifts) and the insurance
companies also were large owners of government debt and
information for the first time a broad segment
of households had financial assets, mostly in
the form of government debt.

The effect of this liquidity was not
a mere away in the 1920s. A main effect
was that business was more independent of their
financiers. A period of "managed capitalism" a
new era of capitalism which has social conscience was
prominely championed in. A new voice: the Committee
for Economic Development had business accept
corporations beloved advice from bankers
and Anti-Trust, in cooperation with
its organized labor front, would not stop it.

Even as "managerial capitalism" was announced,
it basis was being eroded. First in housing and
then clearly in corporate indebtedness was
mining. Business moved from holding government
debt to holding commercial paper and bank certificate
of deposit. By the early 60's the liquidity of
banks and businesses in their holdings of government
debt was gone; even though the government regularly
ran deficits, the rate of growth of government debt
was lower than the rate of growth of GNP; the
rate of increase of government debt minus rate of increase was falling.

By the early 60's the regime's
largely fixed rates were financing of
the savings and loan associations. The Federal Reserve
IV Concluding Considerations.

The conclusion may well follow Winston Churchill's remark about Democracy which, I believe, went that
"Democracy is the worst of all political systems until you contemplate an alternative. So with
Communism. Communism is the worst of all economic systems until you contemplate the alternative. However,
just as with Democracy, Communism has its many
gains as well as downsides."

Socialism, in its various forms, has had a long history in many countries, particularly those
that have been under Communist rule. The vision of a
Soviet State has often been associated with its
failure and societal issues. We should note that
some of the Eastern European states are transforming
themselves in ways that the Soviet
state was never able to.

I believe that the very techniques which made
sophisticated capitalist society enable to technological progress
also have the potential to improve the
The consequences are not trivial when monetary policy authorizes banks to write liability structures in the economy when they make policy. In the series of "credit crunches" of the 1960s and early 1970s, the Federal Reserve found that it could ease monetary policy to have "disintermediation" upon bank and thrift: this "disintermediation" brought a stabilizing impact upon "inflationary" pressures by hurting banks and the specialized institutions that funded house mortgages. By these periods being were shut only a few housing financing institutions were hurt.

When Volcker became Chairman of the Board, he initiated a regime designed to protect the dollar's "quasi-money" measures and made the cut with financing position and the degree of funds that supported monetary policy were no longer major concerns. Monetary policy making between 1978 and 1982. But the interest rates of that period worked out the equity and the market values of financial securities.
Mexico and the other Latin American
Economies look decayed South. Citibank
all but failed since it finds itself
at the mercy of saving states and the not overly
the S&L's disinterested. The last opened
the door to mass deposit: Only "protection
deposit" now had was the government
and the government money fund was no longer
protected by the 5% 72 security pool.