The Modeling of Financial Instability

'Financial instability' is defined as the development of a financial and economic environment in which small disturbances or shocks can cause large changes over a short period of time in financial relations among economic sectors. The repercussions of these large changes permeate through the entire economy. Historically, financial instability has been associated with the major business cycles and the great depressions of experience.

A model of financial instability has two facets:

Inasmuch as the financial system is not always susceptible to aspects of any theory of financial instability, the theory specification of processes by which a stable-irresistible financial environment is transformed into an unstable-riskful financial environment. With the development and maturation of the theory of debt, it is now possible to trace the evolution of financial institutions across and within sectors in considerable detail. Given a theory of how credit flows are related to economic system performance and an interpretation of how balance sheet relations
simply cash flow commitment, it is now possible to develop measures of how accumulated financial relations affect the insensitivity of the economy to financial disturbances.

By interpreting the "measure of financial instability" with a ceiling and floor view of the endogenous determinants of business cycles, a model in which the severity and duration of various cyclical stages of the economy is explained better described. This model draws our attention to variables which at present are not well integrated into theories of the cyclical process and yet hold out promise of enabling us to both better understand and better predict the performance of the economy.