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Article

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Intervention. European Journal of Economics and Economic Policies

Provided in Cooperation with:

Edward Elgar Publishing

Suggested Citation: Asada, Toichiro (2012) : Modeling financial instability, Intervention. European Journal of Economics and Economic Policies, ISSN 2195-3376, Metropolis-Verlag, Marburg, Vol. 09, Iss. 2, pp. 215-232, <https://doi.org/10.4337/ejeep.2012.02.06>

This Version is available at:

<https://hdl.handle.net/10419/277245>

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Modeling financial instability

*Toichiro Asada**

In this paper, we reconsider Minsky's financial instability hypothesis from the point of view of mathematical macrodynamic modeling. We start from a simple prototype small scale model of private debt and income with fixed prices. This system is similar to the Lotka-Volterra predator-prey system, in which private debt plays the role of predator and income plays the role of prey. Then, we extend the model step by step by introducing variable prices, inflation expectation, public debt and a budget equation of the consolidated government including the central bank. We also study the effect of macroeconomic stabilization policies by means of monetary and fiscal policies.

JEL classifications: E12, E31, E32, E44, E52, E62

Keywords: Minsky's financial instability hypothesis, Lotka-Volterra system, private debt, income, public debt, inflation expectation, stabilization policy

I. Introduction

In contrast to the claim of mainstream (Neoclassical) teaching that the capitalist economy is inherently stable, the American Post Keynesian economist Hyman Minsky (1919–1996) proposed the financial instability hypothesis, which means that the financially dominated capitalist economy is inherently unstable (cf. Minsky 1975, 1982 and 1986). It seems that the credibility of Minsky's hypothesis has been rapidly increasing in recent times, since we

* Chuo University. Thanks are due to the valuable comments by two anonymous referees. Needless to say, however, only the author is responsible for possible remaining errors. During this research, the author was financially supported by the Japan Society for Promotion of Science (Grant in Aid (C) 20530160) and the Chuo University Grant for Special Research.

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Received 21 January 2012, accepted 24 April 2012

experienced the Japanese long term deflationary depression in the 1990s and the 2000s after the bubbly prosperity in the 1980s, the Latin American and Asian currency crises in the 1980s and the 1990s, and the global financial crises in the USA and Europe that were initiated by the so called ›subprime mortgage crisis‹ of the US economy in 2008 after the prosperous period of the US economy in the 1990s and the 2000s. It looks as if the world economy in the recent 30 years has been faithfully tracing Minsky's scenario of financial instability hypothesis.

In this paper, we shall try to present some formal mathematical models that are inspired by Minsky's ideas. This paper is organized as follows. In section 2, we restate Minsky's financial instability hypothesis by referring to Minsky's own writings. In section 3, we interpret Asada's (2001) very simple fixed price dynamic model which is expressed by a Lotka-Volterra type two-dimensional system of nonlinear differential equations, which can reflect Minsky's perspective of a financially driven business cycle called ›Minsky cycle‹. In section 4, we interpret the extended three-dimensional model by introducing price flexibility following Asada's (2004) procedure, and show that the *increase* of price flexibility tends to *destabilize* rather than stabilize the macroeconomic system in this model contrary to the teaching of the mainstream macroeconomics.

Minsky's financial instability hypothesis means that the financially-driven capitalist economy is inherently unstable. But, according to Minsky (1986), the stability/ instability of the system is by no means independent of the macroeconomic policies of the government and the central bank. That is to say, the appropriate policy mix of the fiscal and monetary policies by the government and the central bank can contribute to ›stabilize an unstable economy‹ if we quote from the title of Minsky's (1986) book. In sections 5 and 6, we present the further extended higher dimensional models that can study the effects of monetary and fiscal stabilization policies analytically. These models are designed to study theoretically what kind of policy mix is appropriate or inappropriate from the point of view of macroeconomic stabilization. We also argue that the analytical conclusions that are derived from these models are quite consistent with the experience of the Japanese economy under the serious deflationary depression in the 1990s and the 2000s, which are called the ›lost twenty years‹. Section 7 is devoted to some concluding remarks.¹

1 Sections 3 and 4 are in fact restatements of the author's previous papers (Asada 2001 and 2004). Availability of these papers is limited among non-Japanese scholars, although these papers are written in English. This is the reason why we sketch the outline of these papers briefly, although we are forced to omit the detailed formulations because of the lack of the space. Main contributions of this paper are sections 5 and 6, which introduce the effect of monetary and fiscal policies into the basic models that are sketched in sections 3 and 4.

2. *Minsky's financial instability hypothesis restated*

Minsky (1975, 1982 and 1986) asserts that the process of endogenous business cycles inevitably entails the endogenous changes of the form of investment financing such that ›Hedge finance → Speculative finance → Ponzi finance‹. Minsky interprets the meanings of these forms of financing as follows.

»If realized and expected income cash flows are sufficient to meet all the payment commitments on the outstanding liabilities of a unit, then the unit will be hedge financing. However, the balance-sheet cash flows from a unit can be larger than the expected income receipts so that the only way they can be met is by rolling over or even increasing debt; units that roll over debt are engaged in speculative finance and those that increase debt are engaged in Ponzi finance.« (Minsky 1986: 203)

Under the depression process, economic agents become quite pessimistic so that they refrain from investment expenditure, and the repayment of the existing debt and hedge finance dominate in such an environment. As the amount of debt decreases, investment activities become more vigorous, and more bold speculative finance becomes dominant. At the last stage of the prosperity, economic agents become excessively optimistic and they become to be engaged in the Ponzi finance that heavily relies on large amount of borrowing. However, the default of a part of economic agents triggers off the financial crises and the economy rushes into the serious depression. Under the depression process, the hedge finance becomes dominant again. In this way, the waves of pessimism and optimism are repeated reciprocally. This is the essence of Minsky's financial instability hypothesis. Minsky's hypothesis forms a striking contrast to the mainstream ›rational‹ expectation hypothesis. Let us quote from Minsky's writings again:²

»Financing is often based on an assumption ›that the existing state of affairs will continue indefinitely‹ (GT: 152), but of course this assumption proves false. During a boom the existing state is the boom with its accompanying capital gain and asset revaluations. During both a debt-deflation and a stagnant recession the same conventional assumption of the present always ruling is made; the guiding wisdom is that debts are to be avoided, for debts lead to disaster. As a recovery approaches full employment the current generation of economic soothsayers will proclaim that the business cycle has been banished from the land and a new era of permanent prosperity has been inaugurated. [...] But in truth neither the boom, nor the debt-deflation, nor the stagnation, and certainly not a recovery of full-employment growth can continue indefinitely. Each state nurtures forces that lead to its own destruction.« (Minsky 1975: 128)

Such a typical scenario of the process of financially-driven business cycles that was presented by Minsky is called a ›Minsky cycle‹.

2 The abbreviation ›GT‹ in this quotation means Keynes's (1936) *General Theory*.

3. *Minsky cycle as a Lotka-Volterra like system*

Minsky himself did not formulate formal mathematical models that reflect his basic idea on the 'financial instability hypothesis'. However, a lot of mathematical models that were inspired by Minsky's idea have been produced up to now since the seminal paper by Taylor and O'Connell (1985) was published.³ In this section, we shall summarize the essence of the model that was presented by Asada (2001) as a typical example of such mathematical models. This approach interprets the 'Minsky cycle' as a kind of Lotka-Volterra system of mathematical biology, which is based on the dynamic interaction of predator and prey.⁴

The reduced form of a system of equations that was presented by Asada (2001) consists of the following two-dimensional system of differential equations:

$$\begin{aligned} \text{(a) } \dot{d} &= f_1(d, y) , \\ \text{(b) } \dot{y} &= f_2(d, y; \alpha) ; \alpha > 0 , \end{aligned} \tag{1}$$

where a dot over the symbol is time derivative, and the meanings of the symbols are as follows: $d = D/K$ = private debt-capital ratio, $Y = Y/K$ = income-capital ratio, D = stock of the real debt of the private firms, K = real capital stock that is owned by the private firms, Y = real national income, α = parameter that reflects the adjustment speed of the disequilibrium in the goods market. Variable y is used as a surrogate variable that reflects the degree of the utilization of capital stock and the rate of employment ($1 -$ rate of unemployment) in the labor market.⁵ In this simplified version of the model, fixed prices are assumed, and the government's economic activity and international transaction are abstracted from.⁶

Furthermore, each partial derivative in this model becomes as follows because of some economic reasons (cf. Asada 2001):⁷

3 Following examples are some of such works. Arena/Raybaut (1998), Asada (2001, 2004 and 2006), Bhaduri (2011), Charles (2008a and 2008b), Charpe et al. (2011), Delli Gatti/Gallegati (1995), Foley (1987), Jarsulic (1990), Keen (2000), Kuroki (1994), Pally (1996) and papers in Semmler (ed.) (1989). Nasica (2000) provides an excellent survey of the related topics.

4 See Gandolfo (2009, ch. 23) for the exposition of the Lotka-Volterra system. Goodwin (1967) is a very famous contribution as a quite interesting application of this system to macrodynamic economic theory. It must be noted, however, that our formulation is the only partial formalization of Minsky's analytical scheme. For example, it is not clear whether the subprime crisis fits our Lotka-Volterra like model well.

5 This procedure, which was adopted by Franke/Asada (1994) can simplify the analysis by saving one state variable, the rate of employment (e). Although this procedure is not a precise method but only an approximation, we can justify this kind of simplification due to high correlation between the two variables y and e (see Franke/Asada 1994).

6 Later, we shall interpret the extended models that can treat the price movement and macroeconomic stabilization policies by the government including the central bank.

7 Asada (2001) showed that we have a set of inequalities (2) if $g_y, |g_d|$ in equation (3) and the firms' marginal propensity of internal retention are sufficiently large.

$$\begin{aligned}
 f_{11} &= \partial f_1 / \partial d < 0, \quad f_{12} = \partial f_1 / \partial y > 0, \quad f_{21} = \partial f_2 / \partial d < 0, \\
 f_{22} &= \partial f_2 / \partial y > 0, \quad \underset{(-)}{f_{11}} \underset{(+)}{f_{22}} - \underset{(+)}{f_{12}} \underset{(-)}{f_{21}} > 0.
 \end{aligned} \tag{2}$$

Equation (1.a) can be derived from the fact that the firms' investment expenditure that exceeds the firms' internal finance must be debt-financed.⁸ Equation (1.b) expresses the 'quantity adjustment' process in the goods market disequilibrium, which implies that the rate of utilization of the capital stock fluctuates according as the excess demand in the goods market per capital stock is positive or negative. In both equations (1.a) and (1.b), the following investment function is incorporated:

$$\begin{aligned}
 g &= g(y, \rho - \pi^e, d); \quad g_y = \partial g / \partial y > 0, \quad g_{\rho - \pi^e} = \partial g / \partial (\rho - \pi^e) < 0, \\
 g_d &= \partial g / \partial d < 0,
 \end{aligned} \tag{3}$$

where $g = \dot{K} / K =$ rate of investment (rate of capital accumulation), $\rho =$ nominal rate of interest, $\pi^e =$ expected rate of price inflation, and $\rho - \pi^e =$ expected real rate of interest. Asada (2001) derived this type of investment function with debt effect from the expected profit maximization behavior of the firms by using the 'principle of increasing risk' suggested by Kalecki (1937 and 1971), which means that firms' risk increases as the investment expenditure increases.

In the simplified model in this section, fixed prices are assumed so that we have $\pi^e = 0$. Furthermore, in this section, we assume that the central bank always acts to keep the nominal rate of interest ρ to be constant, which means a lack of the active monetary policy. Therefore, π^e and ρ do not enter into the system of equations (1) as variables.

In this model, the change of the private debt-capital ratio d becomes an *increasing* function of the income-capital ratio y ($f_{12} > 0$), because the increase of y induces the increase of debt financing through the rise of the investment expenditure g . On the other hand, the change of the income-capital ratio y becomes a *decreasing* function of the debt-capital ratio d ($f_{21} < 0$), because the increase of d induces the decrease of the investment expenditure, which contributes to the reduction of the excess demand in the goods market through the decrease of effective demand. These characteristics imply that we can consider the system of equations (1) as a 'Lotka-Volterra' like system, in which the variable d plays the role of the predator and the variable y plays the role of the prey.

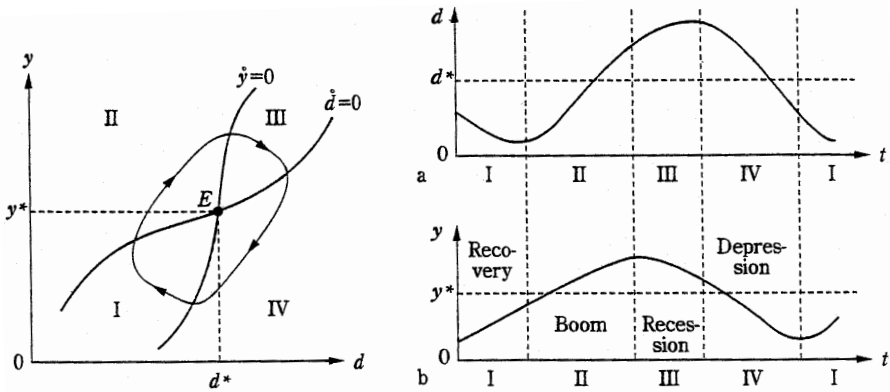
Asada (2001) proved that the cyclical fluctuations occur and in particular, the closed orbits around the equilibrium point exist at some range of the parameter value α by means of the Hopf bifurcation theorem.⁹ Figure 1 illustrates a typical closed orbit of income and private debt that is produced in this system and the time trajectories of two variables corresponding to four phases of the closed orbit. The cyclical fluctuations of income and private debt in Figure 1 can be considered as a typical example of the 'Minsky cycle'.

8 It is assumed that the firms are debtors and the capitalists are creditors, and the issues of new shares are abstracted from.

9 See Gandolfo (2009, ch. 24) for the exposition of the Hopf bifurcation theorem.

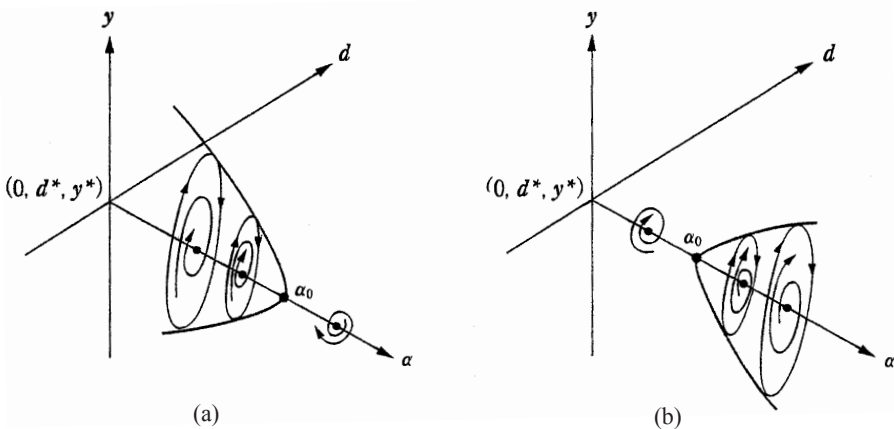
Figure 2 illustrates two types of bifurcation that can emerge in this system.¹⁰ Figure 2 (a) is an example of the ›subcritical‹ Hopf bifurcation. In this case, the closed orbit exists in the range of the parameter value α at which the equilibrium point is locally stable and the closed orbit itself is unstable. Figure 2 (b) is an example of the ›supercritical‹ Hopf bifurcation. In this case, the closed orbit exists in the range of the parameter value α at which the equilibrium point is locally unstable and the closed orbit itself is stable.

Figure 1: Emergence of Minsky cycle



Source: Asada (2001: 81)

Figure 2: Subcritical Hopf bifurcation (a) and supercritical Hopf bifurcation (b)



Source: Asada (2001: 83)

10 Here we omit the detailed interpretation how to derive Figures 1 and 2 because of the lack of the space.

Both of the above mentioned two types of Hopf bifurcation are economically meaningful. The ›subcritical‹ case corresponds to the ›corridor stability‹ in the sense of Leijonhufvud (1973), which means that this system is immune from small shocks that can contain the initial position inside the ›corridor‹ (stable region), but it is vulnerable to large shocks that leave the initial condition outside the ›corridor‹.¹¹ In the ›supercritical‹ case, the time trajectory of the variables that starts from the initial condition other than equilibrium point converges to the limit cycle, and the cyclical fluctuations persist indefinitely.

4. An extension to the model with flexible prices

In this section, we introduce price flexibility into the model of the previous section following Asada's (2004) procedure. We can formulate this extended model by means of the following three dimensional system of differential equations.

$$\begin{aligned} \text{(a) } \dot{d} &= f_1(d, y, \pi^e; \varepsilon); \quad \varepsilon > 0, \\ \text{(b) } \dot{y} &= f_2(d, y, \pi^e; \alpha); \quad \alpha > 0, \\ \text{(c) } \dot{\pi}^e &= f_3(y; \gamma, \varepsilon); \quad \gamma > 0, \end{aligned} \tag{4}$$

where the meanings of the symbols d , y , and α are the same as those in the previous section, and the meanings of other symbols are as follows, π^e = expected rate of price inflation, ε = parameter that reflects the price adjustment speed, γ = parameter that reflects the adjustment speed of price expectation. Furthermore, the following properties of the partial derivatives as well as a set of inequalities (2) in the previous section are assumed.

$$f_{13} = \partial f_1 / \partial \pi^e > 0, \quad f_{23} = \partial f_2 / \partial \pi^e > 0, \quad f_{32} = \partial f_3 / \partial y > 0. \tag{5}$$

We can derive equation (4.c) as follows. In this extended model, the rate of price inflation π becomes an endogenous variable that fluctuates according to the following standard type of the expectations-augmented price Phillips curve.

$$\pi = \varepsilon(y - \bar{y}) + \pi^e; \quad \varepsilon > 0. \tag{6}$$

As for the price expectation formation, the following ›adaptive‹ expectation formation hypothesis (or the ›backward-looking‹ expectation formation hypothesis) is adopted.

$$\dot{\pi}^e = \gamma(\pi - \pi^e); \quad \gamma > 0. \tag{7}$$

Under the absence of the central bank's active commitment to inflation targeting like the Japanese economy under deflationary depression during the 1990s and the 2000s, it is likely

11 See also Asada (2010) for the interpretation of the ›corridor stability‹.

that the people who do not have any definite information form their inflation expectation adaptively. This is the rationale of the hypothesis included in equation (7). Substituting equation (6) into equation (7), we have

$$\dot{\pi}^e = \varepsilon\gamma(y - \bar{y}) = f_3(y; \gamma, \varepsilon) , \tag{8}$$

which is nothing but equation (4.c).

In this model, the nominal rate of interest is still kept constant by the central banker's passive monetary policy. Nevertheless, the real rate of interest becomes a variable rather than constant through the variable expected rate of price inflation, so that the variable π^e enters into equations (4.a) and (4.b) through the investment function (3). Both of the rates of change \dot{d} and \dot{y} become increasing functions of π^e (that is, $f_{13} > 0$ and $f_{23} > 0$) because of the following reasons. The increase of π^e implies the decrease of $\rho - \pi^e$, which induces the increase of the rate of investment and the increase of the debt financing of its expenditure as well as the increase of effective demand.

We can consider the increase of the parameter value ε or γ as the increase of the price flexibility. Asada (2004) proved analytically, however, that the increase of price flexibility in this sense tends to *destabilize* rather than stabilize the economic system contrary to the teaching of the mainstream economic theory, because the following destabilizing positive feedback mechanism is intensified by the increase of the parameter values ε and γ which contributes to intensify the amplitude of macroeconomic fluctuations.

$$\pi^e \downarrow \Rightarrow (\rho - \pi^e) \uparrow \Rightarrow g \downarrow \Rightarrow y \downarrow \Rightarrow \pi \downarrow \Rightarrow \pi^e \downarrow . \tag{FM_1}$$

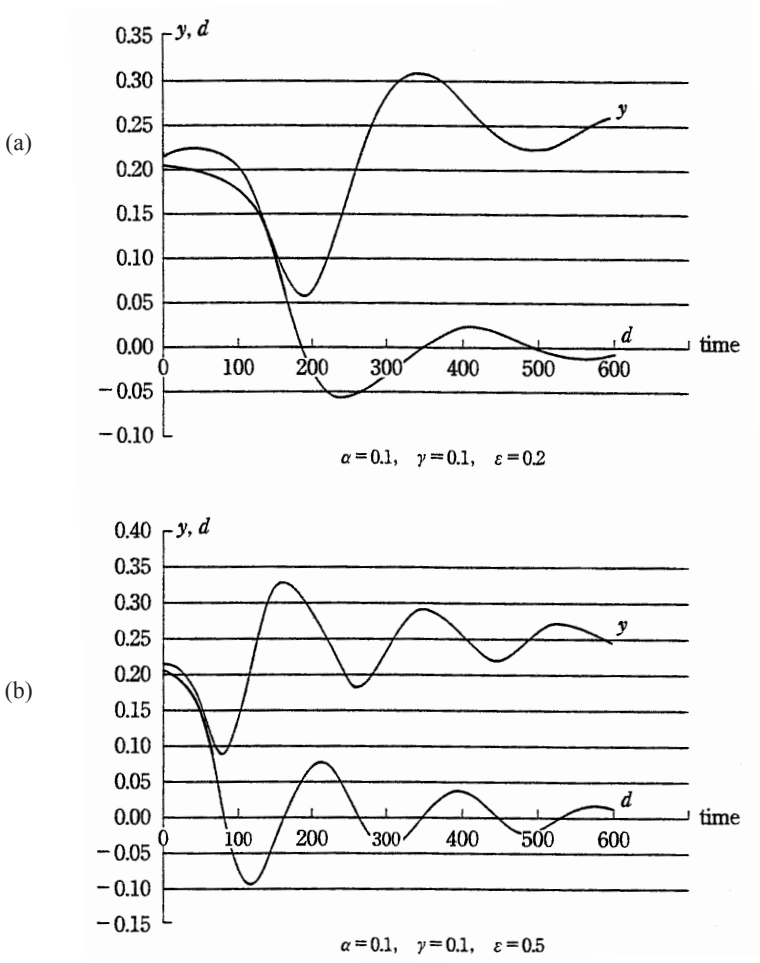
Figures 3 and 4 summarize the result of Asada's (2004) numerical simulations that support the above analytical conclusion.

Incidentally, we pointed out in the previous section that the variable d plays the role of 'predator' and the variable y plays the role of 'prey' in the dynamic interaction between these two variables like the Lotka-Volterra system of mathematical biology. The role of the variable π^e is, however, not so simple. It follows from the system of equations (4) that both of the following results (A) and (B) apply.

- a) π^e is the food for d and y .
- b) y is the food for π^e .

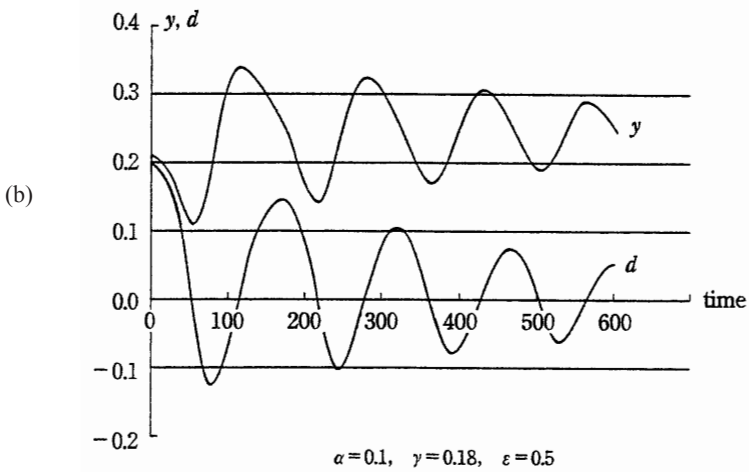
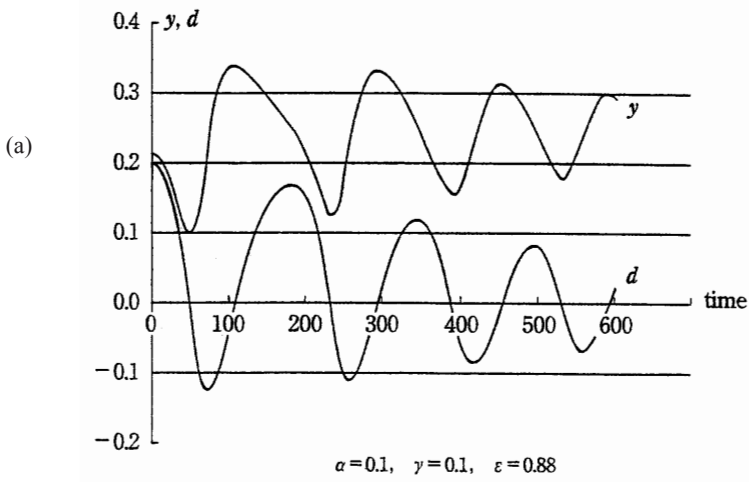
This means that the relationship between two variables π^e and y is not a simple predator-prey relationship and these variables share their destiny. This is the source of the destabilizing positive feedback mechanism that is described schematically by the causal relationships (FM_1).

Figure 3: Numerical illustration (1)



Source: Asada (2004: 50)

Figure 4: Numerical illustration (2)



Source: Asada (2004: 51)

5. Modeling monetary stabilization policy

Now, we are in a position to consider how we can study the effect of monetary stabilization policy by using the analytical framework of the model that was interpreted in section 4. Let us assume that the central bank controls the nominal rate of interest by means of the following feedback monetary policy rule, which is a kind of Taylor rule as proposed by Taylor (1993).¹²

$$\dot{\rho} = \begin{cases} \beta_1(\pi - \bar{\pi}) + \beta_2(y - \bar{y}) & \text{if } \rho > 0 \\ \max[0, \beta_1(\pi - \bar{\pi}) + \beta_2(y - \bar{y})] & \text{if } \rho = 0 \end{cases}; \beta_1 > 0, \beta_2 > 0 \quad (9)$$

We can interpret this policy rule as a kind of flexible inflation targeting rule, which considers both of the inflation targeting and the employment targeting. In this formulation, the nonnegative constraint of the nominal rate of interest is explicitly considered.¹³

It will be appropriate to replace the inflation expectation formation equation (7) in section 4 with the following new equation in case the central bank announces the target rate of inflation $\bar{\pi}$ to the public.

$$\dot{\pi}^e = \gamma[\xi(\bar{\pi} - \pi^e) + (1 - \xi)(\pi - \pi^e)]; \quad \gamma > 0, 0 \leq \xi \leq 1 \quad (10)$$

This equation formalizes a mixed type of inflation expectation formation hypothesis, which means that the inflation expectation formation has both of the 'forward looking' and 'backward looking' elements. The parameter ξ is the weight of the 'forward looking' element. We can interpret the value of the parameter ξ as a measure of the credibility of the inflation targeting by the central bank. The more credible the inflation targeting, the larger will be the value of ξ .¹⁴

We obtain the following relationships substituting the equation of price Phillips curve (6) into equations (9) and (10):

$$\dot{\rho} = f_4(y, \pi^e; \varepsilon, \beta_1, \beta_2) = \begin{cases} \beta_1 \{ \varepsilon(y - \bar{y}) + \pi^e - \bar{\pi} \} + \beta_2(y - \bar{y}) & \text{if } \rho > 0 \\ \max[0, \beta_1 \{ \varepsilon(y - \bar{y}) + \pi^e - \bar{\pi} \} + \beta_2(y - \bar{y})] & \text{if } \rho = 0 \end{cases}, \quad (11)$$

$$\dot{\pi}^e = \gamma[\xi(\bar{\pi} - \pi^e) + (1 - \xi)\varepsilon(y - \bar{y})] = f_3(y, \pi^e; \gamma, \varepsilon, \xi) \quad (12)$$

12 Formalization of the monetary policy by means of the Taylor rule became popular since so called 'New Keynesian' dynamic models that are represented by Woodford (2003) and Galí (2008) took the leading position in the mainstream macroeconomics. Choice of the nominal rate of interest rather than nominal money supply as a monetary policy instrument is now common in Post Keynesian as well as New Keynesian literature. As for the related literature in Post Keynesian tradition, see, for example, Arestis/Sawyer (2008), Asada (2010 and 2011), Asada et al. (2010a), Hein (2007), Isaac (2009) and Setterfield (2009).

13 This type of nonnegative constraint is in particular important in Japan in the 1990s and the 2000s under long period deflationary depression and the USA and European countries in the late 2000s after the serious financial crises.

14 See Asada et al. (2011).

Equations (4.a), (4.b), (11) and (12) consist of the following four dimensional system of nonlinear differential equations, where ρ in equations (4.a) and (4.b) is no longer constant.

$$\begin{aligned}
 \text{(a)} \quad \dot{d} &= f_1(d, y, \pi^e, \rho; \varepsilon); \quad \varepsilon > 0, \\
 \text{(b)} \quad \dot{y} &= f_2(d, y, \pi^e, \rho; \alpha); \quad \alpha > 0, \\
 \text{(c)} \quad \dot{\pi}^e &= f_3(y, \pi^e; \gamma, \varepsilon, \xi); \quad \gamma > 0, 0 \leq \xi \leq 1, \\
 \text{(d)} \quad \dot{\rho} &= f_4(y, \pi^e; \varepsilon, \beta_1, \beta_2); \quad \beta_1 > 0, \beta_2 > 0.
 \end{aligned} \tag{13}$$

The equilibrium solution $(d^*, y^*, \pi^{e*}, \rho^*)$ of this system such that

$$\dot{d} = \dot{y} = \dot{\pi}^e = \dot{\rho} = 0, \tag{14}$$

satisfies the following relationships:

$$y^* = \bar{y}, \quad \pi^{e*} = \pi^* = \bar{\pi}, \quad f_1(d^*, \bar{y}, \bar{\pi}, \rho^*) = 0, \quad f_2(d^*, \bar{y}, \bar{\pi}, \rho^*) = 0. \tag{15}$$

We can see that the equilibrium value of each variable is *independent* of the parameter values β_1, β_2 and ξ . Examining the 4×4 Jacobian matrix of the system (13) at the equilibrium point, we can prove the following proposition.¹⁵

Proposition 1

- (1) Suppose that all of the parameter values β_1, β_2 and ξ are sufficiently small (sufficiently close to 0). Then, the equilibrium point of the system (13) becomes locally unstable.
- (2) Suppose that β_1 and β_2 are sufficiently large and ξ is sufficiently close to 1. Then, the equilibrium point of the system (13) becomes locally stable.¹⁶
- (3) At the intermediate values of the parameters β_1, β_2 and ξ , cyclical fluctuations around the equilibrium point occur.

This proposition means that the central bank's active monetary policy that is combined with the 'credible' inflation targeting can 'stabilize an unstable economy' even if the dynamics of

¹⁵ We omit the proof because we need some tedious long calculations to prove this proposition that is related to such a high dimensional dynamic system. We can use the method of the proof that is used in Asada et al. (2010a) extensively.

¹⁶ The concept of stability and instability in our model is the traditional one that is applicable to the case in which all initial values of the endogenous variables are pre-determined, unlike the mainstream 'New Keynesian' models in which some variables are treated as not-pre-determined 'jump' variables. Namely, we consider that the equilibrium point is locally stable *if and only if* all the roots of the characteristic equation at the equilibrium point have negative real parts. As for the critique of the 'New Keynesian' methodology that allows for the 'jump' variables, see Asada (2010), Asada et al. (2010a), and Asada et al. (2011).

private debt and capital are explicitly considered unlike the standard models of monetary policy.¹⁷

6. Analysis of the policy mix of monetary and fiscal stabilization policies

Finally, we shall try to construct a theoretical framework that can analyze the dynamic effect of the policy mix of monetary and fiscal policies. For this purpose, the following two equations play important roles.

$$M / (pK) = m(\rho)H / (pK) = \phi(\rho)y; \quad m_\rho = dm / d\rho > 0, \quad \phi_\rho = d\phi / d\rho < 0, \quad (16)$$

$$pT + \dot{B} + \dot{H} = pG + \rho B, \quad (17)$$

where $M = mH$ = nominal money stock, H = nominal high-powered money, m = money multiplier > 1 , p = price level, T = real tax, G = real government expenditure, and B = stock of nominal public debt.

Equation (16) is nothing but a standard type of LM equation that describes the equilibrium condition of the money market. We can see, however, that the high-powered money per capital stock $H/(pK)$ in equation (16) becomes an endogenous variable if the central bank controls the nominal rate of interest ρ rather than the money stock according to the Taylor rule that is expressed by equation (9). Equation (17) is the budget constraint of the consolidated government that includes the central bank. This equation shows that the government expenditure including the interest payment of the public debt must be financed by (a) tax, (b) new issue of the public debt, and (c) money financing of the central bank.¹⁸

It follows from equation (17) that we can obtain the following dynamic of the public debt-capital ratio $b = B/(pK)$.

$$\frac{\dot{b}}{b} = \frac{\dot{B}}{B} - \frac{\dot{p}}{p} - \frac{\dot{K}}{K} = \frac{pG + \rho B - pT - \dot{H}}{B} - \pi - g(y, \rho - \pi^e, d). \quad (18)$$

Rewriting this equation leads to the following relationship.

$$\dot{b} = \frac{G}{K} - \frac{T}{K} - \frac{\dot{H}}{pK} - \{\rho - \pi - g(y, \rho - \pi^e, d)\}b. \quad (19)$$

If we neglect the indirect effects of the change of b on \dot{b} through the changes of T/K and other variables, we have

$$\partial \dot{b} / \partial b = \rho - \pi - g. \quad (20)$$

¹⁷ Needless to say, the sentence 'stabilizing an unstable economy' is the quotation of the title of Minsky's book (Minsky 1986). See also Asada et al. (2010b).

¹⁸ We assume that the capitalists purchase both government and private bonds.

We can see from this result that the inequality

$$\text{real rate of interest} = \rho - \pi > g = \text{real rate of capital accumulation} , \quad (21)$$

or equivalently, the inequality

$$\text{nominal rate of interest} = \rho > \pi + g = \text{nominal rate of capital accumulation} , \quad (22)$$

acts as a *destabilizing* factor of the system, and the inequality

$$\text{real rate of interest} = \rho - \pi < g = \text{real rate of capital accumulation} , \quad (23)$$

or equivalently, the inequality

$$\text{nominal rate of interest} = \rho < \pi + g = \text{nominal rate of capital accumulation} , \quad (24)$$

acts as a *stabilizing* factor of the system.

Needless to say, these inequalities are only partial conditions for instability/stability. Nevertheless, these conditions provide us some insight concerning instability/stability of the system. The (partial) stability condition (23) or (24) is called 'Domar condition' after Domar (1957). It must be noted that the nominal rate of interest ρ cannot become negative. Therefore, it is likely that the destabilizing 'anti Domar condition' (21) or (22) is satisfied if the rate of inflation π is negative and the real rate of capital accumulation g is negative or almost zero. In fact, this was the case of the Japanese economy in the 1990s and the 2000s under long term deflationary depression, during which the public debt-capital ratio b increased rapidly.¹⁹

Now, let us formulate the fiscal policy rule as follows.

$$\dot{v} = \beta_3[\theta(\bar{y} - y) + (1 - \theta)(\bar{b} - b)]; \quad \beta_3 > 0, 0 < \theta < 1 , \quad (25)$$

where $v = G/K$ and \bar{b} is the target public debt-capital ratio that is set by the government. This is the feedback rule of the government expenditure that considers both the stabilization of the real national income (employment) and the stock of public debt. The parameter θ is the weight of the relative importance of national income (employment) consideration compared with the public debt consideration that is attached by the government.

The equations (16), (19) and (25) together with equation (13) consists of a six-dimensional system of nonlinear differential equations with six endogenous variables (d, y, π^e, ρ, b, v).²⁰ Equations (13.d) and (25) formalize the policy mix of monetary and fiscal policies in this model.

19 In Japan in this period, the nominal annual rate of interest of the long term national debt was on average between 1 per cent and 2 per cent, and the nominal annual rate of economic growth was in average only 0.1 per cent. This means that the destabilizing 'anti Domar condition' (22) was in fact satisfied in Japan in this period (cf. Asada 2011).

20 We assume that T/K is a function of y and b . Furthermore, we suppose that both of \dot{d} and \dot{y} are not independent of the variables b and v .

Proposition 1 in the previous section also applies to this extended system. Furthermore, we can show analytically that the *large* value of the parameter θ (value of θ that is close to 1) is a *stabilizing* factor and the *small* value of θ (value of θ that is close to 0) is a *destabilizing* factor.²¹ This means that the appropriate policy mix is the combination of the active monetary policy with sufficient credibility and the fiscal policy that attaches importance to the employment consideration rather than public debt consideration. The opposite policy mix is inappropriate. If the policy mix is inappropriate, the equilibrium point becomes dynamically unstable, and in this case the deflationary depression, in which the nominal rate of interest is stuck at its lower bound, is likely to occur like in the Japanese economy in the 1990s and the 2000s.

The intuitive explanation of this conclusion is as follows. Suppose that the government expenditure responds actively to the changes of real national income (employment). Then, the following stabilizing negative feedback mechanism will work.

$$y \downarrow \Rightarrow v \uparrow \Rightarrow (\text{effective demand per capital stock}) \uparrow \Rightarrow y \uparrow . \quad (FM_2)$$

On the other hand, the following two destabilizing positive feedback mechanisms will work if the government expenditure responds to the changes of the stock of public debt excessively.

$$y \downarrow \Rightarrow (T / K) \downarrow \Rightarrow b \uparrow \Rightarrow v \downarrow \Rightarrow (\text{effective demand per capital stock}) \downarrow \Rightarrow y \downarrow , \quad (FM_3)$$

$$b \uparrow \Rightarrow v \downarrow \Rightarrow y \downarrow, (T / K) \downarrow, (H / p) \downarrow \Rightarrow b \uparrow . \quad (FM_4)$$

These destabilizing feedback mechanisms produce the paradoxical situation in which the *decrease* of the government expenditure per capital stock induces the *decrease* of real national income per capital stock (employment) and the *increase* of debt-capital ratio, contrary to the government's subjective intention.

This theoretical reasoning is consistent with the experience of the Japanese economy in the 1990s and the 2000s, which are called the 'lost twenty years'. We already noted that the destabilizing 'anti Domar condition' was satisfied in Japan in this period. In fact, in Japan in this period of serious deflationary depression with high unemployment, the sharp *increase* of the public debt-capital ratio b coexisted with the *decrease* rather than increase of both of government expenditure-capital ratio v and income-capital ratio y together with the *decline* of the growth rate of money stock (cf. Asada 2011). These apparently paradoxical behaviors of some key variables in Japan in recent twenty years are quite consistent with the theoretical reasoning of the model in this section.

21 In this paper the mathematical proofs are omitted because of the lack of space. Full mathematical proofs will be presented in another paper of the author.

7. *Concluding remarks*

In this paper, we presented some dynamic models that can contribute to formalize Minsky's idea of financial instability hypothesis, and furthermore presented some models that can contribute to the dynamic analysis of the macroeconomic stabilization policies by means of the monetary and fiscal policies. We hope that these models can successfully give an answer to the question »what policy mix is appropriate to stabilize an inherently unstable economy in the sense of Minsky?«

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