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Keynes, Minsky, and Me

by

William H. Janeway
University of Cambridge & Warburg Pincus

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Levy Economics Institute
P.O. Box 5000
Annandale-on-Hudson, NY 12504-5000
http://www.levyinstitute.org

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INTRODUCTION

This talk grows out of three relationships: my own with John Maynard Keynes and Hyman Minsky, respectively (and respectfully), and—the central subject of the talk—Minsky's relationship with Keynes.

KEYNES AND ME

My relationship with Keynes began a decade before I was born.

Very early in my eccentrically creative father's passage through journalism to the role of consulting political economist, he visited London in 1932: his residence was punctuated by a brief visit to see the future at work in Moscow. In London he discovered Keynes and *his* work, which fortunately overshadowed Marxism-Leninism. The result, with a certain lag, was that I grew up in an intellectual environment deeply informed by the central pillars of Keynes's work, from *The Economics Consequences of the Peace* (1919) to *The General Theory* (1936), and on to *How to Pay for the War* (1940). From an undergraduate degree in Princeton's equivalent of Oxford's Philosophy, Politics, and Economics degree, I received a Marshall Scholarship to Cambridge to pursue a doctoral degree in what was then—as it had been in Keynes's day—the Faculty of Economics and Politics. In order to be accepted by the faculty, I was required to produce a substantial paper on *The General Theory*, nothing I hasten to add approaching the depth of analysis that Minsky delivered in his *John Maynard Keynes* (1975), less than a decade later. Nonetheless, it anchored my understanding of economic and financial processes in the economics of Keynes versus the transiently dominant "Keynesian Economics."

As it happened, the Labour Government of Harold Wilson had changed the rules on open disclosure of public documents from 50 to 30 years, effective on January 1, 1968. So, all the public documents covering the life and miserable death of the Labour Government of 1929–31 would then be available. My thesis on its confused and inadequate economic policies was supervised by Professor Richard Lord Kahn, Keynes's student and academic executor.

As unemployment rose from 1 to 2 million and the fiscal deficit followed, the policy debate within the Government became a battle between Keynes, as a cross between an outside provocateur and an inside advisor, versus the Treasury, the dominant power center of any peacetime British administration from Gladstone to the present day.

The Treasury won, hands down, as it did again some 80 years later in the UK's adoption of austerity following the Global Financial Crisis and in the midst of the Great Recession. For myself, I had become too deeply immersed in Keynes's economics to be capable of teaching the bastardized, Neoclassical version of it—so characterized by Cambridge's Joan Robinson—on offer from MIT. The sticking point for me was what Hayek later termed "the presumption of knowledge" about the consequences of forward-looking decisions, most significantly investment decisions. I could not live with the refusal of the mainstream Neoclassical Synthesis to acknowledge the inescapable uncertainty with which we must live. Hence my departure from Cambridge and academia for a 35-year sabbatical as a venture capitalist, where radical uncertainty was the air one breathed and learning how to hedge against it was the most important of all survival lessons.

The peak of that experience came in 1999 as the Internet Bubble reached *its* peak. Through my Cambridge thesis, I had seen this movie before and knew how it ended. We liquidated my entire portfolio in time and for great profit. In gratitude and recognition, I proposed to fund at Cambridge, "The Keynes Institute for the Study of Money and Finance in Economic Theory and Practice." Given the state of the discipline, my timing could not have been worse. Rational Expectations dominated; Keynes had been discredited, but then came the Global Financial Crisis. Keynes—along with Minsky—was rediscovered.

ME AND MINSKY

I myself discovered Hy Minsky in the mid-1980s when I was visiting my cousin in St. Louis. Dick Gordon had been a senior research chemist at Monsanto—hence, St. Louis—and by then

had moved into consulting. He was a board member of the Mark Twain Banks, where Minsky also served. Dick brought us together over dinner. It rapidly became clear that we shared first principles of economics, rooted in Keynes's thought and work. Minsky sponsored one of my relatively few brushes with academia during my sabbatical years: a paper presented to the Annual Meeting of the Association for Evolutionary Economics in December 1985.

My paper was entitled "Doing Capitalism: Notes on the Practice of Venture Capitalism" (1986). It tracked the differing profiles of the "financial agent" in the works of Fernand Braudel, Karl Marx. Josef Schumpeter, and Keynes, drawing parallels from each with the modern professional venture capitalist. I think what caught Minsky's attention was when I translated Marx's formula for Merchant Capitalism—C-M-C´, the use of money to buy commodities to resell, at a profit, for more money—by substituting company for commodity, thus characterizing the sequential path of the venture capitalist through time. When Minsky moved to the Levy Institute, it became relatively easy for me to interrupt commuting to Silicon Valley in order to attend conferences here and to converse with Minsky and his students, notably Randy Wray and Jan Kregel.

That 1985 paper served as the seed for the book, also called *Doing Capitalism*, that I first published in 2012, the better part of 30 years later. Still following where Keynes had led, I addressed the Economics of Innovation, where investment at the frontier of technology to pioneer new markets necessarily takes place under conditions of radical uncertainty and in volatile financial conditions. The invitation to give this talk has led me to retrace my steps in order to appreciate the fundamental depth of Minsky's understanding of Keynes and his strategic extensions of Keynes's work, with direct relevance for the discipline of economics today.

MINSKY AND KEYNES

Now we come to the central subject of this talk. I will divide my discussion into three parts. I will begin with Minsky's *John Maynard Keynes* (1975), where he reconstructs with rigor the incomplete and somewhat confused and confusing microfoundations of *The General Theory* (1936). I then will consider how Minsky's intense focus on the liability structure of a monetary

production economy logically engenders the Financial Fragility Hypothesis. Finally, I will turn to Minsky's expansion of Keynes's suggestion at the end of *The General Theory* that "a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment" (378).

In the background of this entire talk is Randy Wray's (2016) excellent book, *Why Minsky Matters*. Please take what I have to say as presenting distinctive points of emphasis linking Minsky's work to that of Keynes: for a more rounded account of Minsky's work as a whole, see Randy's book. In particular, take to heart the most abiding message Randy takes from Minsky: the fixation of economists on defining the conditions for equilibrium evades a central, existential truth, "stability is destabilizing," a message I shall expand upon when I come to the Financial Fragility Hypothesis. Minsky (1975, 55) set out to explicate what he identified as Keynes's "investment theory of fluctuations in real demand and financial theory of real investment." He began by walking carefully through "the conventional wisdom, the standard interpretation of Keynes," which had effectively served to obscure what Keynes had achieved and abort the revolution in economic theory he had launched.

Throughout, Minsky (1975) repeatedly cites Keynes's invocation of uncertainty as the fundamental factor conditioning economic and financial decisions: "Keynes without uncertainty is something like Hamlet without the Prince" (55). As Keynes insisted in his response to Jacob Viner in the *Quarterly Journal of Economics* (1936), uncertainty is effectively an ontological condition of the universe in which we happen to live.

> By "uncertain' knowledge" I do not mean merely to distinguish what is known from what is merely probable. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest 20 years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.

That is to say, Paul Davidson was *right*: the data-generating processes whose output economists study are non-ergodic; and Cassius was *wrong*: the fault, Dear Brutus, *does* lie in our stars.

The argument moves from metaphysics to the sublunary plane of financial economics as soon as

Keynes, and with him Minsky, turns to money. It is all very well to note the convenience that money brings as a medium of exchange, expunging the need for discovery of a coincidence of wants to initiate trade. But why hold money as an asset, a hoard, when by construction it yields no income? As Keynes (1936) put it provocatively, "why would anyone outside a lunatic asylum wish to use money as a store of wealth?" The answer, of course, is as *insurance* against all that cannot be known in advance.

Money is unique among assets for its extreme liquidity, complementing its lack of return. Keynes's invention of "liquidity preference" encapsulated his recognition that interest rates represent the "premium" that must be offered to induce investors *not* to hold cash. All other assets are subject to their own changing, context-dependent liquidity.

Liquidity preference cannot be a stable function since it is not an attribute of an asset. Rather, it is an attribute of the market conditions in which it becomes subjectively desirable or even objectively necessary to convert the given asset into cash. As anyone who has lived—as Keynes did—inside the financial markets knows the perverse attribute of liquidity is well known: the more you need it, the less available it is. This is one avenue through which uncertainty informs investment decisions.

The motivation to acquire and hold any asset other than money, of course, is the yield it will return to the owner. For the yield on capital assets, Minsky follows Keynes in using Marshall's term "quasi-rent," because it incorporates both uncertainty about what future yields will actually turn out to be as well as some forecast of the liquidity which would actually be available to the owner of that asset if and when needed. We are already in a world where the technical productivity of the capital asset cannot on its own define its marginal efficiency.

This is the path that leads to construction of the demand price for capital assets, the physical embodiment of investment. Here, Minsky directly criticizes Keynes for inviting confusion by arguing about the investment function in terms of interest rates rather than asset prices.

This is a door, if you like, through which Hicks entered to propose a radically and misleadingly

simplified alternative to Keynes's economics in the IS-LM formulation. In his 1937 *Econometrica* paper, "Keynes and the Classics" (1937), investment becomes a simple function inversely related to the rate of interest and equal to savings in equilibrium. In turn, liquidity preference is dumbed down into a demand function for money, equal in equilibrium to an exogenously given supply of money. Expectations and uncertainty are banished from center stage and even from the wings of the theatre.

For me, the core of Minsky's analysis of the economics of Keynes comes in his explication of the process through which investment is determined. This process involves three types of asset: money, debts (or "contracts exchanging present money for future money"), and real capital assets ("characterized by expected yields that may vary for a number of reasons"). Minsky (1975) writes:

> The determination of investment, therefore, is a four-stage process in *The General Theory*. Money and debts determine an "interest rate"; long-term expectations determine the yield – or expected cash flows - from capital assets and current investment…; the yield and the interest rate enter into the determination of the price of capital assets; and investment is carried to the point where the supply price of investment output equals the capitalized value of the yield. The simple IS-LM framework violates the complexity of the investment-determining process as envisaged by Keynes. In the literature, the puzzles with respect to the determination of investment put forth by Keynes have been ignored rather than solved. (35)

A generation after his presentation of IS-LM, Hicks (1980) published "IS-LM: an Explanation." Here he set forth various reasons for which "I have myself become dissatisfied" with what by then had long since become the standard, summary formulation of Keynesian Economics. Appropriately enough, it appeared in *The Journal of Post Keynesian Economics*. Hicks emphasized that the central relationships encapsulated in IS-LM are *equilibrium* relationships, which means they must be maintained through time. In turn, this means that: "Expectations must be kept self-consistent…That can only be possible if expectations…are *right*. Equilibrium over time thus implies consistency between expectations and realisations …"(151, citing *Capital and Growth* 1965, 93, emphasis in original). But, Hicks (1980) goes on, "there is no sense in liquidity, unless expectations are uncertain." Thus, Hicks pulled a central brick from the foundations of the Neoclassical Synthesis, belatedly providing a critique which neither Keynes—first sidelined by a mild heart attack and then thoroughly engaged in financing the War—nor his students, Richard Kahn and Joan Robinson, delivered in real time.

As it happens, Brad Delong (2026) of Berkeley has just provided an intensive analytical review of what he calls "Hicks's Apostasy."[1] Throughout the last 25 years of his life, Hicks attempted to bring down the structure through which "The Economics of Keynes" was translated into "Keynesian Economics."

For Keynes, the fragility of any transient equilibrium amongst the relationships that together determine the rate of investment is explicit in the central role of "long-term expectations," subject to rapid revision as the problematically prospective future morphs into the present. As Minsky subsequently wrote, "any reference by Keynes to an equilibrium is best interpreted as a reference to a transitory set of system variables towards which the economy is tending; but…as the economy moves…endogenously determined changes occur which affect the system variables toward which the economy tends." Rather more clearly, Minsky writes:

> …[T]he core of Keynes's system consists of an *analysis of capitalist finance in the context of uncertainty, and of how capitalist finance affects the valuation of items in the stock of capital assets and thus affects the pace of investment.* (129, emphasis in original)

Given the relatively passive nature of the consumption function, the fluctuations of investment drive fluctuations in aggregate demand and in the economy as a whole. Here we have, in sum, the Investment Theory of Aggregate Demand and the Financial Theory of Investment. From this perspective, the supposed link between the technical productivity of the "K" specified in the neoclassical production function and the rate of investment is confounded both by the variability of the prospective yield from the asset, taking uncertainty and liquidity preference into account, and the variability between the discount rate applied to the yields expected from owning specific assets and the money rate of interest.

Furthermore, both the demand and supply prices of capital are denominated in nominal money terms, as are the debt obligations assumed to finance their purchase. The neoclassical Keynesian tradition has a long history of evading the fact that in the actual existing labor markets of the actual existing world, employers and employees can only bargain over *money* wages. In the actual existing real world's financial markets, debt liabilities are also denominated in nominal

[1] https://braddelong.substack.com/p/not-my-john-hicks-lecture-john-hicks

terms. The real wages embedded in production functions and reduced form macro equations only are realized after the fact.

This confusion has left standing the most fundamental flaw in the handbook of macroeconomic policy: that the root cause of persistent unemployment is that money wages are too high and that reducing unemployment requires that they be lowered. Both the neoclassical and New Keynesian versions of macroeconomics use wage stickiness to legitimize policy interventions to augment aggregate demand and avoid the bitter struggle to force wages down. Minsky correctly interpreted Keynes to understand that, in a world of debt contracts set in nominal money terms, downwardly flexible wages and prices would threaten to unleash the destructive debt-deflation described by Irving Fisher, and experienced by the United States in 1930–33. To Keynes and to Minsky, wage stickiness is a feature of the system, not a bug.

THE FINANCIAL FRAGILITY HYPOTHESIS

Minsky's (1975) entire restatement of *The General Theory* is enriched by his linking the acquisitions and ownership of assets to the liabilities incurred to finance their purchase. Minsky's economic units are like "little banks" that pay for assets by issuing liabilities. They sit at the intersection of cash flows from the assets they own and the cashflows they are obliged to make to their creditors. From this construction, Minsky called out Keynes' identification of "the entrepreneur's or borrower's risk…of his actually earning the prospective yield for which he hopes" and "lender's risk" of voluntary or involuntary default by debtors (104). "The fundamental fact about borrower's and lender's risks is that they reflect subjective valuations." Minsky quotes Keynes, "During a boom the popular estimation of both of these risks…is apt to become unusually and imprudent low" (110). Here we can find the roots of the Financial Fragility Hypothesis for which Minsky is best known within the discipline and among the educated lay public.

In a Levy working paper from 1992, Minsky proposed two theorems. First, "the economy has financing regimes under which it is stable and financing regimes in which it is unstable."

Second, "[o]ver periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system." Stability is de-stabilizing: the credit system and the economy at large progress (or degenerate) through successive stages of rising confidence and risk-taking.

The initial, conservative stage is that of *hedge finance*: the operating cash flows of borrowers are sufficient to service outstanding debts and to repay them as they mature. As expectations of borrowers and lenders are validated by experience, they jointly move into the phase of *speculative finance*. Operating cash flow is sufficient to make timely payments of interest, but the principal must be rolled over and refinanced to prevent default and hence is exposed to changing market conditions. This is the speculative element. Finally, the system moves into the stage of *Ponzi Finance*, where debtors must borrow the interest they owe to indulgent lenders in order for the fiction of solvency to be maintained.

Minsky operationalized the liability structure that the investment activities of firms engender as "budget constraints." Through a neat model, Minsky shows how the tightness of budget constraints at firm and aggregate levels turns on the extent to which investments can be funded from operating cash flow versus external finance. Where and when the budget constraint will bind, in turns, depends upon the firm's access to liquidity: from current cash holdings, from new security issues, or from liquidating assets.

Within mainstream neoclassical economics, the Global Financial Crisis generated a range of relevant responses that often explicitly invoked Minsky. Before the fact, during the run up to the Global Financial Crisis, anyone attuned to Minsky's analysis of financial fragility could have taken note of a phenomenon that had emerged in the LBO market by 2006, fully two years before Lehman's bankruptcy. The popular rediscovery of Minsky under the shock of the GFC was typically expressed in the meme, "The Minsky Moment," but of course Minsky defined a *process*, not a moment. The stage that process had reached in 2006 was identifiable: banks were funding their customers with "PIK-Toggle" debt instruments.

Translated for civilians, this meant that debtors could service their obligations by issuing more

debt rather than with cash ("PIK" means "Payment in Kind") and the decision as to whether to do so was entirely within the discretion of the borrower (the "Toggle"). No clearer evidence that the system was in the Ponzi Regime could be imagined. What is more, the state of confidence was such that a three-year put option on the S&P 500 (the right for three years to exchange this derivative for cash valued at the *current* price of the index) could be purchased for only 2 percent per year: Thank you, Hy Minsky!

In macroeconomics, pioneers in the rediscovery of the significance of balance sheets notably included Richard Koo of the Nomura Research Institute and Paul Krugman, both of whom looked back to Japan's "lost decades" from 1990 through the Global Financial Crisis to define a "balance sheet recession" and used it to explain the Great Recession. Professor Patrick Bolton (2011), now at Imperial College Business School in London, with his colleagues Hui Chen and Neng Wang, in their paper "A Unified Theory of Tobin's *q*, Corporate Investment, Financing, and Risk Management," analyze budget constraints at the level of the firm:

> We propose a model of dynamic investment, financing, and risk management for financially constrained firms. The model highlights the central importance of the endogenous marginal value of liquidity (cash and credit line) for corporate decisions.

My life as a venture capitalist validated Minsky's theorizing and anticipated Bolton's version. As my brilliant and challenging mentor, Fred Adler put it: "corporate happiness is positive cash flow." The ability to pay your debts because your customers pay you more in cash than it costs to develop and deliver what you are selling liberates the firm from dependence on the problematic, essentially unknowable future state of the financial markets.

For a venture capitalist funding startups, the imminence of Minsky's "survival constraint"—the point at which all sources of cash from operations, securities issuances, and asset sales have been exhausted—is always a real-world threat. The episodic bubbles that magically relieved the threat present the quintessence of uncertainty: you know each will burst, you just don't know when.

BIG STATE CAPITALISM

I will conclude with a consideration of Minsky's extension of Keynes to the post–World War II regime of Big State Capitalism. In the *General Theory*, Keynes analyzed the dynamics of Small State Capitalism. Before moving on, I must pause to quantify in simple terms the difference between these two political economies. In 1929, the total public sector of the United States amounted to 4 percent of national income of which half was accounted for by the federal government (principally the postal and customs services plus very modest armed services) and half by state and local governments (the largest component was school teacher salaries). Indeed, that aggregate share almost doubled between the Wall Street Crash and FDR's Inaugural, but that was because nominal national income declined by almost 50 percent, half of which was "real" and half from deflation. State governments were constrained by their own constitutions to balance their budgets, cutting expenditures as tax revenues fell. However, the doubling of the federal government's share to 4 percent was the result of the Hoover administration's passive acceptance of the debt-deflation juggernaut.

During the summer of 1964, I served as research assistant to Professor Lester Chandler of Princeton, a doyen of old-school money-and-banking finance, who was on his way to publish *American Monetary Policy, 1929-1941*, a neglected corrective to Friedman and Schwartz's *Monetary History of the United States*. At the time, the Council of Economic Advisors was promulgating the concept of the full-employment budget deficit as a useful rationale for the Kennedy-Johnson tax cuts of that year. Professor Chandler guided me through a back-of-the-envelope estimation of the magnitude of the federal deficit in 1933 that would have been roughly consistent with full employment. I recall the number we came up with was about three times the size of total federal expenditure in 1932, a year in which net private sector investment was negative: new investment spending was less than depreciation of the capital stock. The conclusion was simple: before the government could stabilize the economy, it had to become much bigger!

Thanks largely to the emergence of the welfare state, from Social Security through Medicare, and the warfare state, due to the Cold War contestation with the Soviet Union, by the time Minsky addressed the existential question—*Can "It" Happen Again?*—the US public sector was

large enough to offset the fluctuations of investment. To explain the stabilizing role the Big State plays, Minsky identified three complementary contributions that substantial fiscal deficits make to a financially stressed economy:

- They augment aggregate demand by increasing income and employment;
- They generate cash flows that protect the firms from the threat of default due to their own reduced investment and increased precautionary savings by households;
- They supply low-risk investment instruments for risk-averse investors.

Minsky continues:

> The effect of Big Government on the economy is much more powerful and pervasive than is allowed by the standard view which neglects the financial-flow and portfolio implications of a government deficit. The standard view focuses solely on the direct and secondary effects of government spending…on aggregate demand. The expanded view allows both for the cash flows that other sectors need to fulfill commitments and for the need for secure assets in portfolios in the aftermath of financial disturbance. (1986, 21)

Minsky's vision extended beyond the macroeconomic fix with which lived history endowed the United States. He sought a much more comprehensive establishment and extension of the New Deal Order, characterized by public orchestration of large, capital-and-debt intensive public works—such as had been delivered by the New Deal's Public Works Administration (the PWA)—and direct provision of employment to idle workers—as had been the responsibility of the New Deal's Works Progress Administration (somewhat confusingly, the WPA). Massive defense budgets as stabilizing forces were a frustrating alternative to socially productive investments for Minsky. Welfare payments were an inadequate substitute for the provision of real work. At a moment when the current administration is hellbent on destroying the capacity of the American state to deliver on any of its socioeconomic responsibilities, Minsky's agenda is sadly off the table.

Minsky's version of Keynes's economics had minimal impact on the mainstream during his own lifetime and in the years following. Its prime messages were echoed a generation later by Luigi Pasinetti, one of the most thoughtful of the Cambridge Keynesians, in his *Keynes and the Cambridge Keynesians: A 'Revolution in Economics' to be Accomplished* (2007). One frustrating explanation Pasinetti offers for his subtitle is the failure of the Cambridge and the American

post-Keynesians (among whom he lists Minsky) to communicate effectively with each other. It is an open question whether any degree of collaboration could have overcome the ideological and political attractions, first, of the Neoclassical Synthesis in the Post-War era and its subsequent displacement in the Reagan era by Rational Expectations.

Something else is going on where Minsky and his work may yet play a role, and it ought not be marginal. The Global Financial Crisis set in motion another process, one that continues however problematically and haphazardly, a process to reconstruct the discipline of economics itself. First, the GFC motivated a shotgun remarriage between economics and finance, led by a cadre of outstanding financial economists, including Markus Brunnermeier, Helene Rey, Jose Scheinkman and Hyun Song Shin. Further, signal evidence of doctrine that had advanced backwards from the Neoclassical Synthesis to Rational Expectations has substantially been addressed. Specifically, the remains of the Representative Rational Optimizing Agent, his own debtor-and-creditor/issuer-and-investor, can be found at the crossroads with a stake through his heart. Room has been rediscovered for a complex financial system to interact with a real economy structured through at least as complex, dynamically evolving networks of production and consumption. This is a project to which Minsky would have had much to contribute, especially bringing to bear the most central element in the economics of Keynes: the inescapable uncertainty that attends all economic and financial commitments.

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