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THOMAS I. PALLEY

Debt, aggregate demand, and the business cycle: an analysis in the spirit of Kaldor and Minsky

Over the last decade interest in the economic consequences of debt has increased significantly. There are numerous reasons for this increase. First, there is the increase in the levels of debt, both private and government, that characterized the decade of the 1980s. Second, there is the widespread belief that the current recession is a "balance sheet" recession, with consumption and investment depressed because households and firms are weighed down by debt service obligations. Third, there is the discovery by Friedman (1983, 1986) of a longstanding stable time-series relation between income and credit, and this in turn has served to redirect attention away from the traditional focus on the money–income relationship.

This growth of interest in the effects of debt ties in with the work of Minsky (1964, 1977, 1982), who has persistently emphasized the role of financial factors in the business cycle. Within the Minskyian framework, the business cycle is characterized by the gradual emergence of "financial fragility," and this fragility ultimately causes the demise of the upswing. Minsky's descriptive model is as follows: The business cycle upswing is characterized as a period of "tranquillity" during which bankers, industrialists, and households[1] become increasingly more "optimistic." In the real sector this optimism translates into increased real investment, while in the financial sector it shows up in the form of an increased willingness to borrow, an easing of lending standards, and an increase in the degree of leverge of debtors. Effectively, there is a

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[1] The role of households and consumer debt is not emphasized by Minsky. In part this is because the massive expansion of consumer borrowing is a relatively recent development, and Minsky's work has been inspired by earlier episodes in American economic history, particularly the Great Depression. However, consumer borrowing can be incorporated into the analysis without difficulty.

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