The Minsky Moment

Source: End This Depression Now, Krugman, cap. 3.

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The Minsky moment in housing

When **house prices** increases everybody can buy an house and after a while having a gain in terms of value.

Even **banks** give easily money because the price of houses tends to increase and even if you are not able to repay your loan they can sell the house at an higher price.

When the price of houses **goes down** things goes bad.

Financial Instability Hypothesis

During periods of stability the **leverage** of agents tends to rise creating the condition for increasing instability:

- Debt is a good thing, allow people to buy an house or to make investment.
- Debt of someone is an asset to someone else.

Financial Instability Hypothesis

- But if many people are too indebted and for some reason at the same time they try to reduce their leverage (economic downturn reduces income), this create a **debt-deflation spiral**.
- If people sell their house the price of houses goes down so the capability of reducing their debt decline, if people consume less, the economy may enter in a deeper recession with even lower income.
- Thus asset prices, but also good prices go down: the **deflation**.

Debt Dynamics in US

During the ′20 the debt in US increased steadily and because of the debt deflation spyral it remain high until the second world war.

During the war no credit but huge growth decreased the level of leverage and allowed the economy after the war to access to loans to invest.

After the ′80s the level of debt started to increase again.

Looking Glass Economics

When in a country the economy slows down and the debt is to high some analyst may say that you have to reduce debt catting expenditure.

But it leads to the **paradox of thrift** the more you save the less demand you have in an economy the more the economy shrinks.

Moreover the economy after the crisis was in a **liquidity trap**, even if the interest was zero investment and consumption do not increased.

A world of paradoxes where virtue is vice and prudence is folly.

Looking Glass Economics

The **paradox of deleveraging** if everybody deleverage asset prices decline and the economy contracts leading in general to lower prices.

The **paradox of flexibility** decreasing wages in order create more jobs but reduce consumption, leading to higher unemployment.

So if family and firms cannot spend government must spend and borrow during a crisis.