

**Financial Instability and Effective Demand :
Theoretical and Empirical Analysis of “Paradox of Debt”**

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Abstract

In the recent Japanese economy, concern has been growing about how a liquidation of non-performing loans held by financial institutions would affect macroeconomic situations. To reduce their indebtedness, firms may be forced to cut investment expenditures and hence the amounts they borrow from financial institutions. A slowdown in capital accumulation reduces the profitability of businesses and makes the firm's own funds insufficient to meet debt service payments. The biggest risk facing the Japanese economy is a vicious circle in which the fragile financial conditions of businesses, non-performing loans held by banks and hence insufficient aggregate demand either do not improve or get worse. Such a vicious circle can be referred to as the paradox of debt. This paper investigates the macroeconomic relationship between financial instability and stagnant aggregate demand, using the Post-Keynesian model of growth and distribution that incorporates financial perspectives such as interest rates set by financial authorities, firms' leverage ratio and rentiers' savings behavior into the effective demand constraint. In addition some empirical analyses are conducted to examine structural features of the macroeconomic situations underlying the financial instability that the Japanese economy has experienced since the late 1990s.