

When Credit Bites Back: a Discussion

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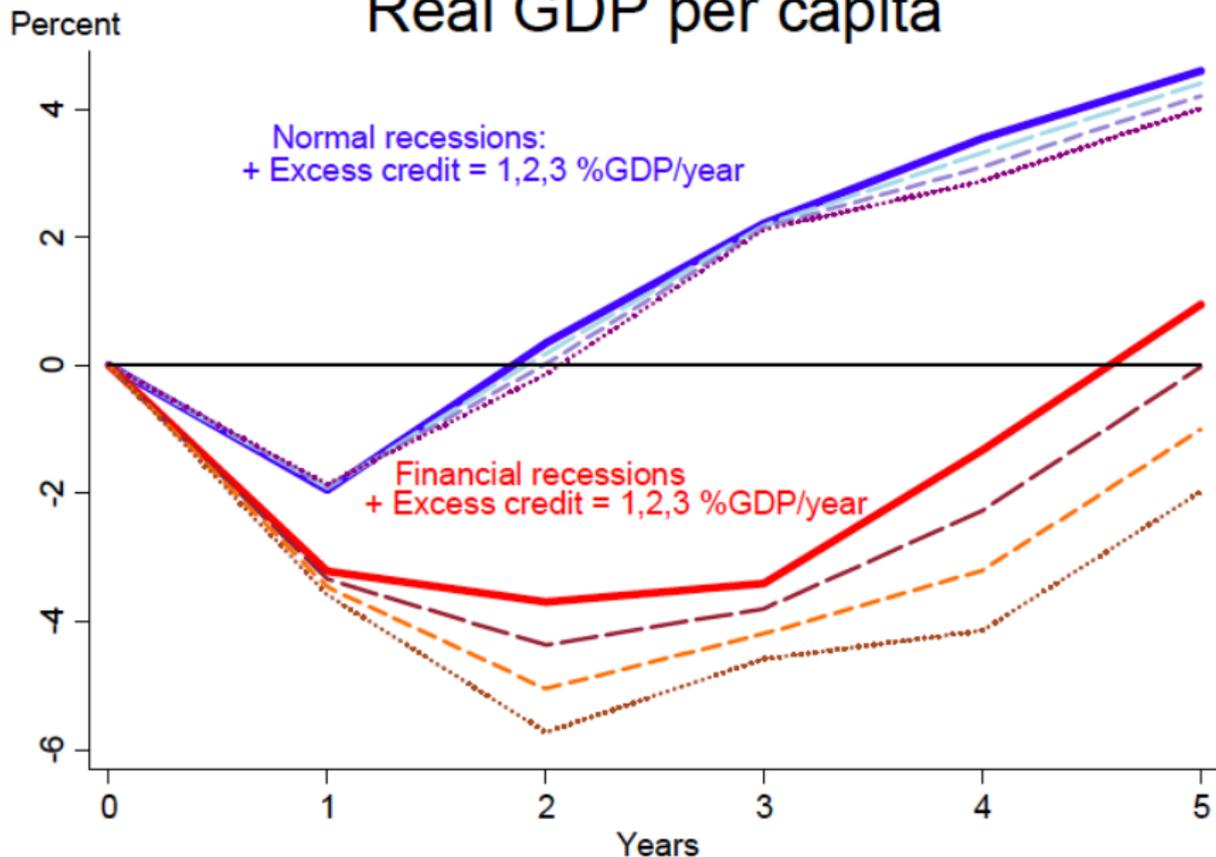
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Main Result

Real GDP per capita





Some Motivation

- ▶ I like economic history (I even teach it!).
- ▶ I like econometrics (in particular, when applied with good taste).
- ▶ I agree with the authors view that finance is a key ingredient in models of aggregate fluctuations.
- ▶ Hence, my general view of the paper must be positive.
- ▶ Now, just praising the paper will make for a dull presentation...
- ▶ ...so I must be somewhat more creative.



A Question I

- ▶ Is credit an epiphenomenon?

Braudel, *La Méditerranée et le monde méditerranéen à l'époque de Philippe II*

l'histoire événementielle de Paul Lacombe et de François Simiand: une agitation de surface, les vagues que les marées soulèvent sur leur puissant mouvement. Une histoire à oscillations brèves, rapides, nerveuses.

Braudel, *The Mediterranean and the Mediterranean World in the Age of Philip II*

The history of events of Paul Lacombe and François Simiand: surface disturbances, waves that the tides raise in their powerful movement. A history of brief, fast, nervous fluctuations.



A Question II

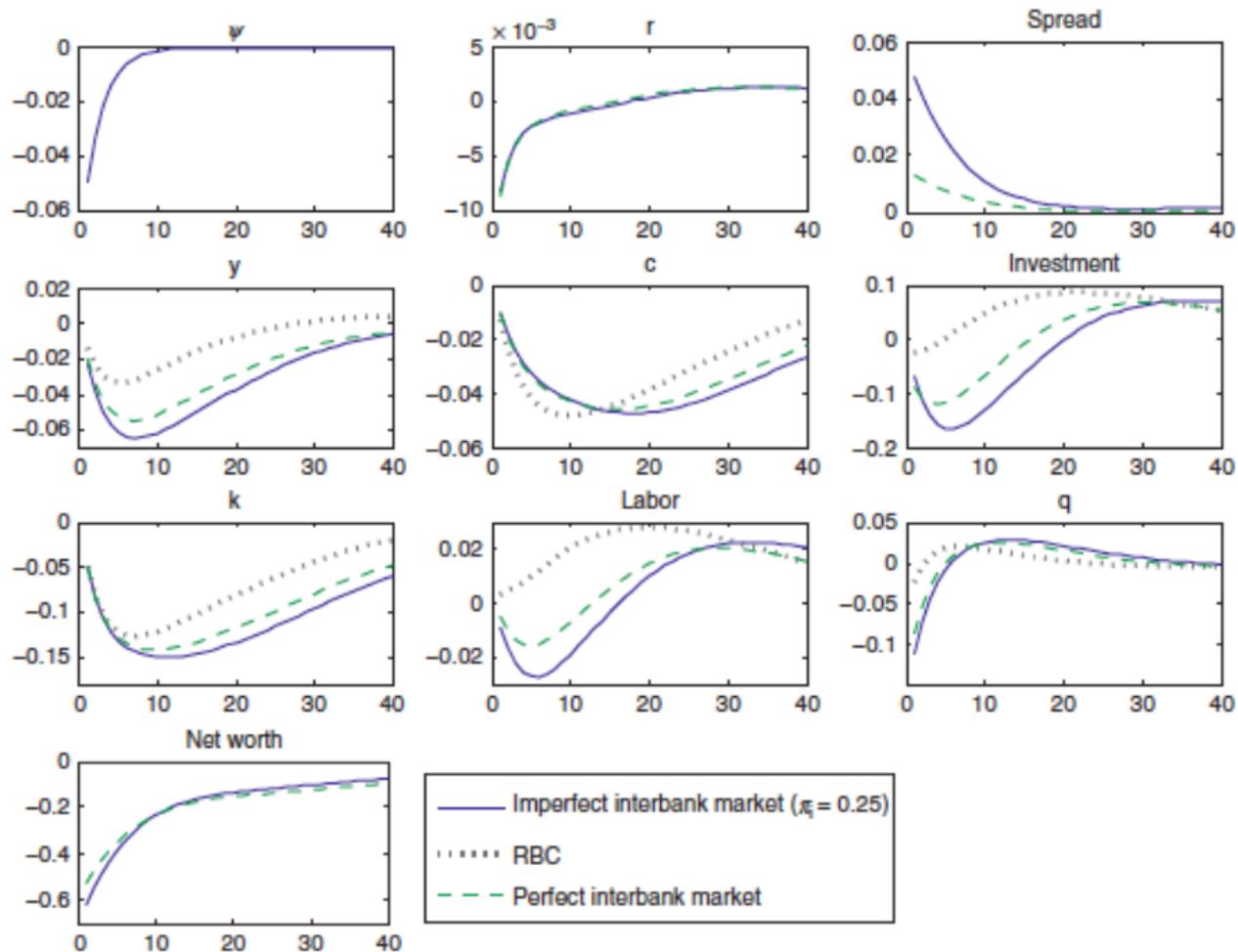
- ▶ Why are recoveries slow?
 1. Something inherent about financial crisis.
 2. Something related with why financial crisis occur.

- ▶ Why is the answer really important?



Alternative 1

- ▶ Financial crisis are, by their nature, painful to recover from.
- ▶ Models that emphasize distribution of wealth.
- ▶ **Kiyotaki and Gertler (2011)**: net wealth of banks.
- ▶ After a shock, recovery is slow because it takes time to rebuild equity.
- ▶ Clear policy prescriptions.
- ▶ General problem of this class of models: leaving a lot of money in the table for different contractual arrangements.
- ▶ Why are those alternative arrangements not occurring?





Alternative 2

- ▶ An alternative explanation: the credit boom is, after all, an epiphenomenon.
- ▶ Computation (or, at least, interpretation) of responses to credit booms is actually harder than it seems.
- ▶ When we measure the responses of the economy to a shock to productivity, terms of trade, or to monetary policy, one can (usually) take the position that the shocks are exogenous.
- ▶ Best example: oil shock in a small open economy.
- ▶ But a credit boom is very different: it is an endogenous object.



What Type of Effects Do I have in Mind?

- ▶ Just as an example: Fernández-Villaverde, Garicano, and Santos (2012).
- ▶ Information extraction hard in bubbles- worse monitoring:
 1. Filtering problem with moral hazard (accountability is lost)
 2. Badly damaged Incentives, selection, and governance.
- ▶ Weak institutions exposed: bubble exposes vulnerabilities, as trouble directed to weakest link (Cajas in Spain, Anglo Irish and Fianna Fáil in Ireland, State Pensions in Greece, Fannie in US.)
- ▶ Not the cause, but the reason the pressure leads to catastrophe.
- ▶ Consequence: weak institutions become weaker during bubbles.
- ▶ Weak institutions difficult the recovery.



Example: Cajas in Spain

- ▶ Spain in the first €-decade received large inflows.
- ▶ A bank-based economy: All through bank balance sheets.
- ▶ The Cajas, unknown abroad, can borrow because of their quasi-public status: implicit guarantee.
- ▶ Deficient governance structure (Cuñat and Garicano, 2010).
- ▶ Not subject to market discipline.
- ▶ Political control.
- ▶ No mechanism for recap in case of solvency concerns.
- ▶ Sovereign debt crisis has to do with the transfer of the potential catastrophic losses in the Cajas to the state.



The Cajas: Institutional Background I

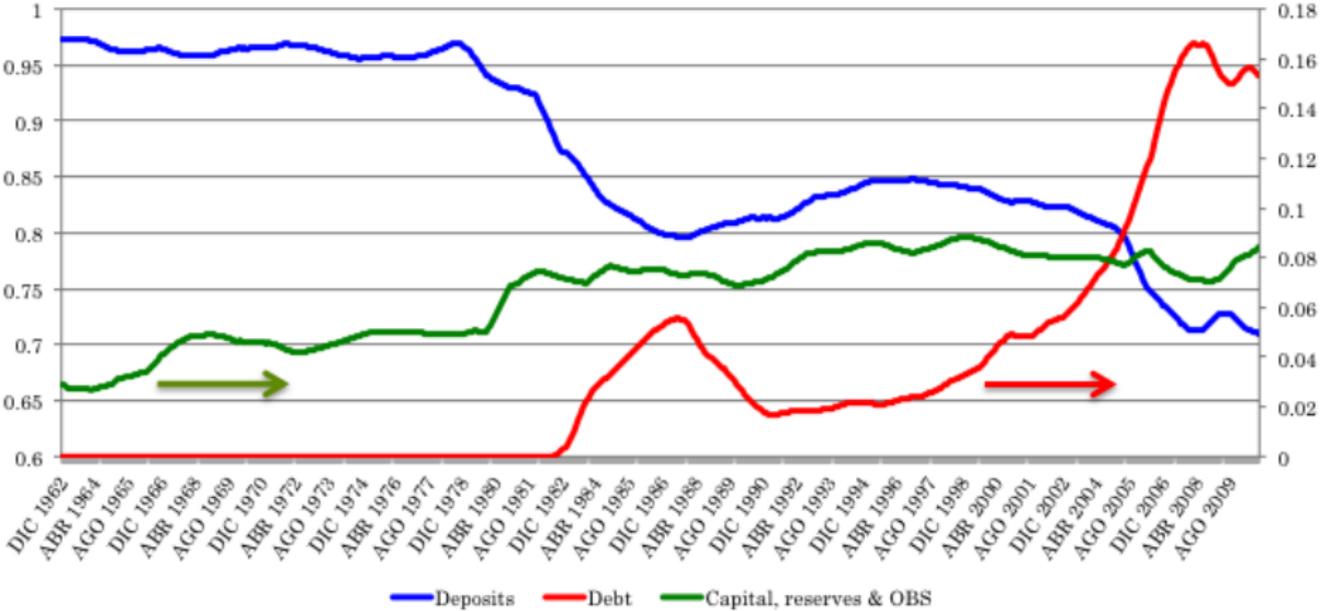
- ▶ Transition to democracy: parties, trade unions created from above, without participation from society.
- ▶ Centralized power structure, controlled from center which dispenses favors.
- ▶ Then decentralization (regions) created from above without any demand from most regions (reaction to Catalan and Basque demands).
- ▶ Serves to create a gigantic patronage system, colonizing regional governments, universities, and..



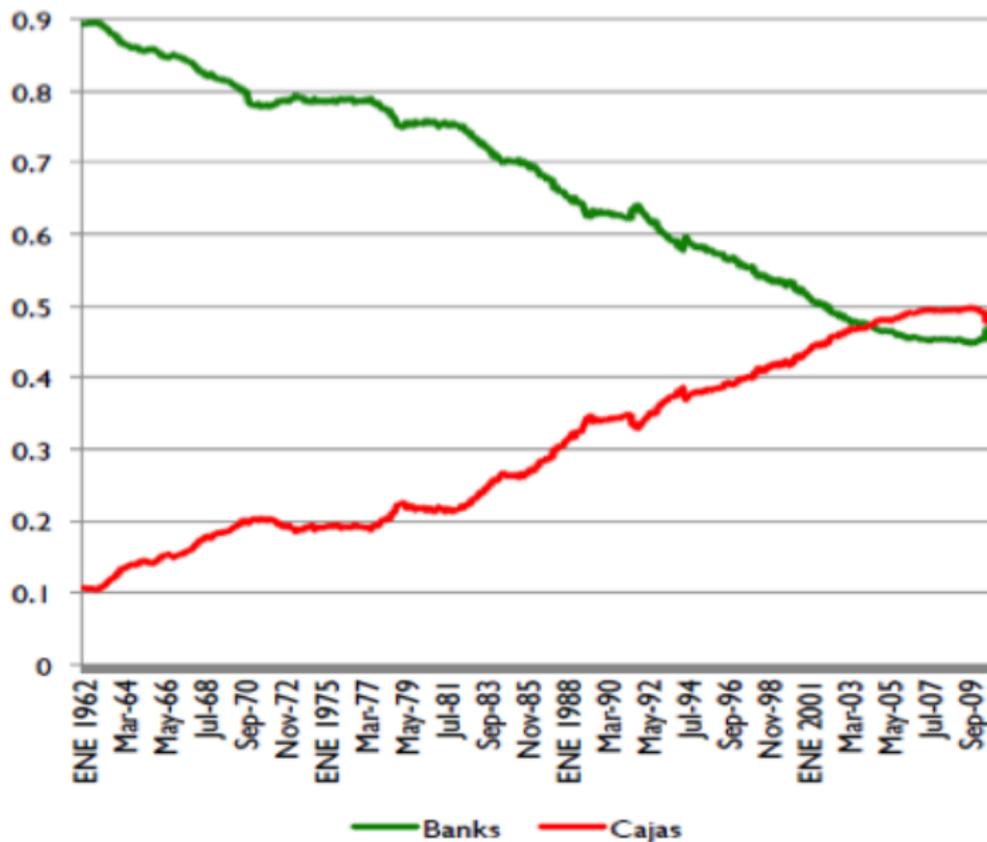
The Cajas: Institutional Background II

- ▶ Cajas: originally small, provincial.
- ▶ Deregulated post 1992 (Single Market).
- ▶ But had easy access to money with EMU.
- ▶ Used, in many cases, as regional development banks, a favor bank, ...
- ▶ Catastrophically affected by the bubble.

Balance Sheets



Share of Deposits





Conclusion

- ▶ The authors make an important contribution studying a universe of 200 recession episodes.
- ▶ The authors make a compelling case in how to measure the effects of financial crisis and of normal crisis when credit has grown a lot.
- ▶ In particular: recoveries are slow.
- ▶ It is less obvious what we should learn from that fact.
- ▶ In particular, we need better empirical studies.
- ▶ Answer is crucial for optimal policy design.