When Credit Bites Back: a Discussion

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Main Result

Real GDP per capita

Normal recessions:
+ Excess credit = 1,2,3 %GDP/year

Financial recessions
+ Excess credit = 1,2,3 %GDP/year
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.


- 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?


- 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

![Graph showing the share of deposits over time with green for Banks and red for Cajas. The graph includes months and years from ENE 1962 to Sep 09.]
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.