

DISCUSSION OF

Costas Azariadis'

CREDIT POLICY IN TIMES OF FINANCIAL DISTRESS

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Recent financial crisis has

- ▶ served as an impetus for a large body of research on its causes and implications
- ▶ motivated taking a closer look at policies to prevent/mitigate crises

Costas' paper focuses

- ▶ on a particular possible (probable?) cause of the crisis:
A credit panic due to an adverse, self fulfilling shock to expected credit conditions
- ▶ on two important central bank policies to cope with (preempt) a collapse of credit
 1. capital (reserve) requirements –CR– on financial intermediaries
 2. lender of last resort (CB accepting deposits and making loans)

The model

A dynamic, endowment economy with

- ▶ complete markets
- ▶ limited commitment by borrowers
- ▶ permanent exclusion from credit markets in the case of default against private creditors

Implication: lack of commitment may result in a debt ceiling (and hence suboptimal consumption smoothing)

The debt ceiling makes sure that there is no default in equilibrium in the model

Key idea

- ▶ the incentive to repay currently due debt depends on the expected value of future participation in credit markets (which depends on the level of debt, time preferences, volatility of future income etc.)
- ▶ expectations of adverse future credit conditions lower the value of participation and increase the incentive to default on current debt
- ▶ the increase in the incentive to default decreases the amount of safe debt that can be issued today

Implication: the expectation of malfunctioning credit markets in the future can lead to the collapse of credit now. Under some conditions, the economy can only support the autarkic equilibrium with zero credit.

What can policymakers do to prevent such an outcome?

- ▶ Institute reserve requirements: The fin.intermediary (lender) pays a small tax (a fraction of which is returned to him in the next period) if he is lending less than the constrained efficient amount.
- ▶ for small enough adverse belief shocks, this suffices to deter credit contraction (default) and keep the economy in the efficient steady state.

Lender of last resort (LLR)

- ▶ The CB is prepared to act as an intermediary: Accept deposits and make loans to the private sector
- ▶ Two specifications about punishment in case of default
 1. if the CB can only prevent defaulters from borrowing but not from saving then the LLR policy eliminates the bad equilibrium
 2. if the CB can totally (borrowing and lending) exclude defaulters from credit markets then it supports an intermediate equilibrium
- ▶ No need to implement the policy. Mere announcement suffices.

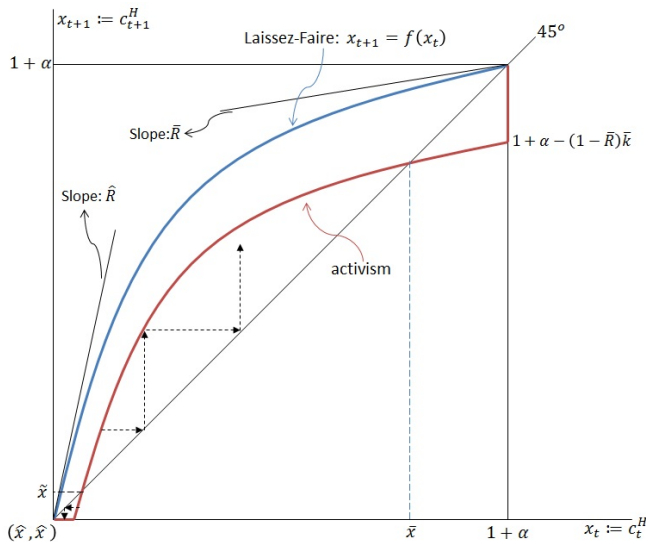
Evaluation

- ▶ Vintage Costas work
- ▶ Interesting, rigorous, elegant, clear
- ▶ Different perspective, food for thought
- ▶ No chicken farm

Some things I do not understand. Perhaps useful to elaborate more on them in the paper

- ▶ The requirement of an almost completely flat policy induced –red– line in the neighborhood of the good state state. Why is it needed? Why isn't sufficient to have a slope less than unity?
- ▶ Small vs large shocks. I understand the math about the creation of a local attractor too close to the inefficient (autarkic) equilibrium. But why can't we set up the p-function (make the tax large enough) in a way that always supports the constrained efficient steady state?
- ▶ Isn't it still good –even with large shocks– to have such a policy in place in order to to get at least some consumption smoothing
- ▶ Does it make a difference whether RR are fully funded rather than pay as you go?

FIGURE :



Connection to empirical facts/ mainstream views of the financial crisis/ nature of appropriate policy responses

- ▶ The Kehoe and Levin, complete asset markets model. The incentive to default is higher when income levels are high. The data seem to favor the opposite, default incentives seem to be higher in bad times.
- ▶ In the model, default tendencies (financial crises) can be mitigated by having countercyclical requirements. Lower requirement-taxes when the intermediaries lend a lot.
- ▶ These two (higher incentive to default in good times, countercyclical reserve requirements) are related.

- ▶ The conventional view (and policies currently contemplated) involve procyclical capital (or reserve) requirements. Want to curtail credit expansion (build capital buffers) in good times and encourage it in bad times.
- ▶ Caveat. The prevailing view has to do with systemic risk and externalities. Costas' model has no aggregate risks and no credit externalities.

- ▶ The source of fragility: Mainstream view is that fragility is the result (is associated with) excessive credit creation (rational exuberance,..) followed by a large reversal. This model does not have a probability of credit market collapses that depends *positively* on the quantity of credit.
- ▶ Commitment asymmetry: Is it reasonable to assume that policymakers can commit to implement the prescribed policies? Incentive compatibility, time inconsistency.

Conclusions

- ▶ Nice, thought provoking piece of research
- ▶ Offers alternative to mainstream views regarding the prevention of financial crises.
- ▶ Would be interesting to explore these policies in a model in which the incentive to default is countercyclical.