Discussion on *Credit Crisis, Precautionary Savings and the Liquidity Trap* (2011) by Guerrieri and Lorenzoni

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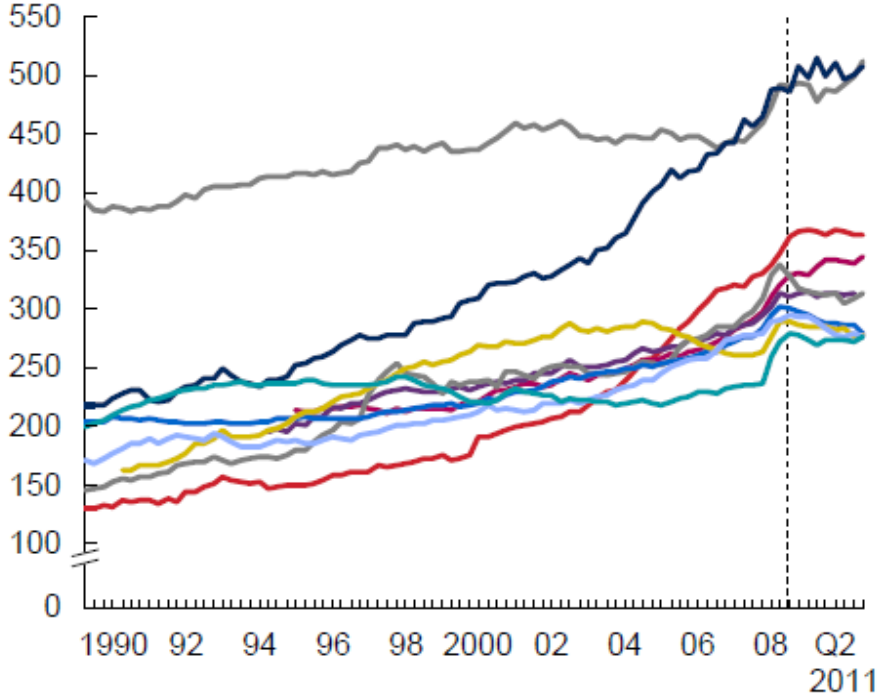
EUI

- This is a relevent paper

Deleveraging has only just begun in the ten largest developed economies

Total debt,[1] 1990–Q2 2011

% of GDP



▲ Significant increase in leverage[2]

▼ Deleveraging

Change
Percentage points

	2000–08	2008–Q2 2011[3]
Japan	37	39 ▲
United Kingdom	177	20
Spain	145	26 ▲
France	89	35 ▲
Italy	68	12
South Korea	91	-16 ▼
United States	75	-16 ▼
Germany	7	1
Australia	77	-14 ▼
Canada	39	17

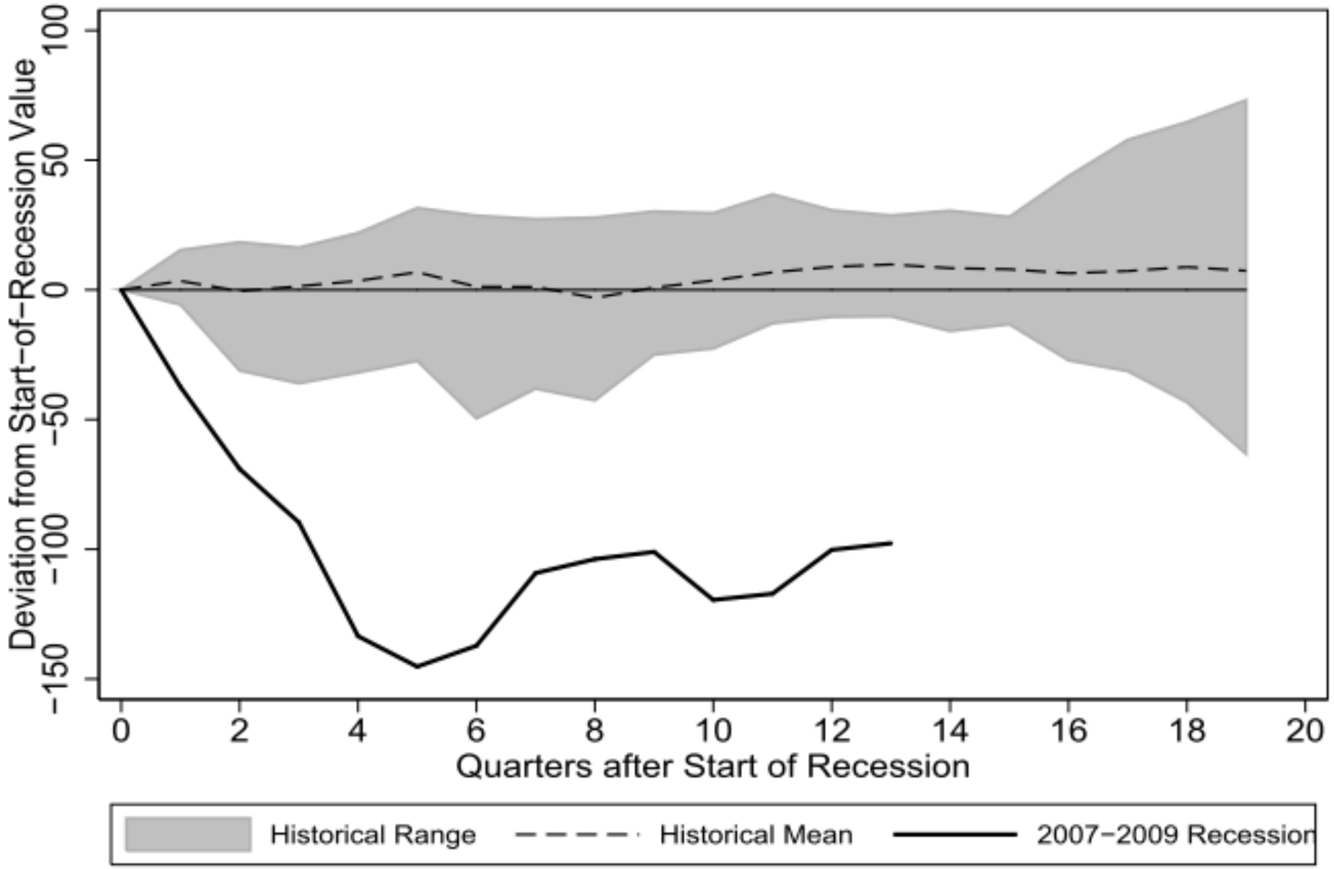
1 Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
2 Defined as an increase of 25 percentage points or more.
3 Or latest available.

SOURCE: Haver Analytics; national central banks; McKinsey Global Institute

- The paper is an attempt to model what has been called a *Balance Sheet Recession*
  - The value of collateral falls
  - Borrowing constraints are tighter
  - Savings increase (sort of Paradox of Thrift)
  - Consumption demand and output falls
  - Liquidity trap. Monetary policy is less effective

- Is this what has happened?
- Savings and Wealth for the US (from Carroll 2012)

Household Wealth 2007– ↓ by 150% of Income



Personal Saving Rate 2007– ↑

The paper

- Standard exogenous incomplete markets model, Bewley model
- To study the effects of a credit tightening on interest rate and output
- It extends the model to incorporate illiquid durable goods which can be used as collateral for loans
- They calibrate the model for the US economy and study the response of output and interest rates after an unexpected permanent tightening in households' borrowing constraint. They study:
  - Transitional dynamics: savings change because i) deleveraging and ii) precautionary savings
  - Comparison across steady states: savings change only because precautionary savings are higher in the second regime

- Should we think this model as a model of crisis?

- I think the model can be improved along some dimensions

Labor market

- After the credit shock, the model predicts that
  - less productive households work more
  - more productive households work less

- But this hardly characterizes the current Great Recession

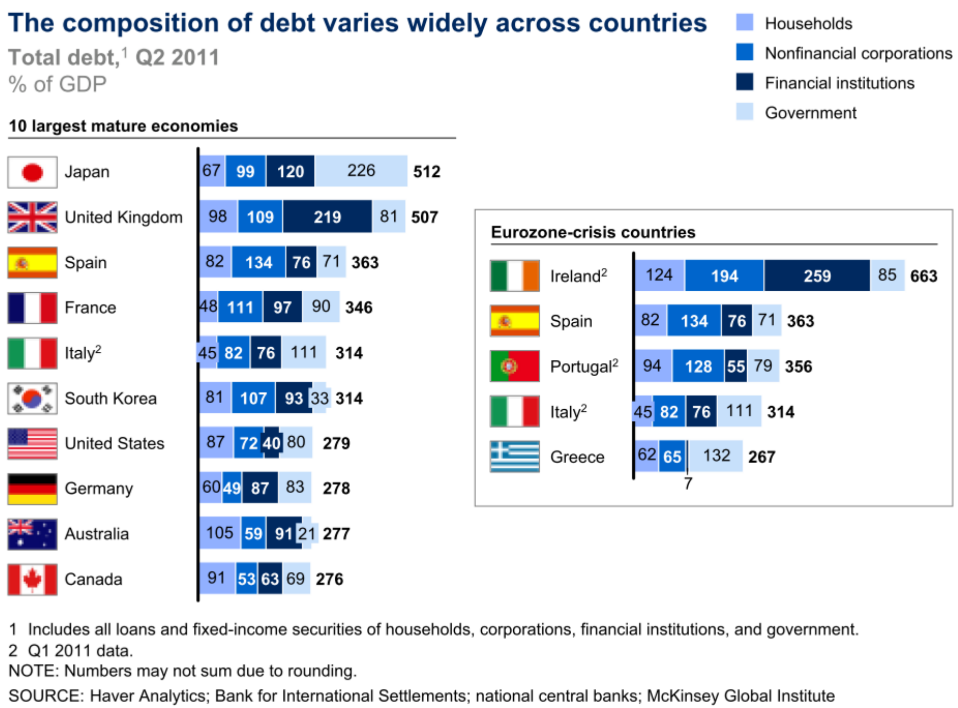
- How to avoid this? → Pawel (2013)

Financial intermediaries

- The model does not incorporate default.
- With the possibility of default in the household sector, balance sheet problems may show up in banks
- Then we can also have a problem of credit supply
- More realistic for some countries like Spain (Peydro et al. 2012)
- Some of us are working on this idea

Firms

- In some countries (Spain, Portugal) firms seem to be leading the deleveraging process.



- Analysis of the household sector could be combined with financial frictions on the firms' side.