Comments on

“The Recent Boom Bust Cycle: The Relative Contribution of Capital Flows, Credit Supply and Asset Bubbles”

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Alan Sutherland
What caused the boom-bust cycle 2000-2010?

TFP growth

Monetary policy

World savings glut

Flight to safety

Housing and stock market bubbles

Financial innovation, sub-prime lending followed by mortgage defaults

Variations in lending criteria
Puzzles

Why was the contraction so severe - what were the amplifying mechanisms?

Defaults are redistributive in standard models - so why would bad debts or default play a major role in the downturn?

What explains the composition of the contraction in GDP? For instance, there was a strong fall in house building followed by a fall in corporate investment, but only a mild fall in consumption.
Approach

Construct a model which includes:
- disaggregated households
- collateral constraints (subject to shocks)
- shocks to TFP
- shocks to foreign savings (savings glut)
- asset preferences (flight to safety)
- bubbles
- defaults

How much does each shock contribute to the boom and the bust?
Conclusions

Savings glut is important but not sufficient to explain the boom.

High TFP growth can explain investment boom but not volatility.

Housing and stock market bubbles appear to be important in the up-turn, but the housing bubble bursts in advance of the crisis and does not appear significant in explaining the down-turn.

Mortgage defaults are important in explaining the down-turn.

Bursting of the stock market bubble plays a significant role in the down-turn.
Comments on the general methodology

In this analysis “shocks” appear to be a measure of how far the model does not fit the data - and the decomposition of the shocks is used as an explanation of the data.

So how should we interpret the contribution of the model to this analysis, relative to the contribution of the shocks?

Presumably a different model would produce a different set of decompositions - so how do we judge whether the model is good and whether the decompositions are good?

Measure of goodness of fit and statistical significance, for the model, for the shock decomposition?

How should we interpret the residuals in the shock decompositions?
Comments on the model

The model treats the crisis as an equilibrium event

The crisis was an “out of equilibrium” event. When the crisis occurred agents had no idea about:

- the size of bad debts or how many or which banks would be affected
- how the losses would be shared across depositors, shareholders, governments, employees, tax payers or government bond holders
- how long it would take to work out how big the losses were or who would bear the cost
- the likely policy response
- the effectiveness of policy

A relatively small amount of bad debts could create a fear in all agents that they will bear a disproportionate share of the cost - so even a zero-sum game may create expectations of a net loss across the population - this is a potentially powerful amplification mechanism
There were fears that the payments system would break down.

There was a run on the banking system which increased banks’ demand for liquidity - not adequately modelled as a tightening in collateral constraints.

Monetary policy responded much more aggressively than the Taylor rule.

QE and bailouts were a major part of the policy response and are not captured by the Taylor rule.

Fiscal policy is not specified in the paper but was also quite aggressive.

Some of the shocks in the model are related - e.g. down-turn in house prices and mortgage defaults.
Some of these points suggest that the model does not capture some potentially important endogenous amplification mechanisms - other points suggest that there are exogenous shocks missing from the model.

Suppose the model was modified to incorporate these mechanisms and the modified model matched the data more closely - this would reduce the size of the residuals and thus reduce the contribution of shocks.

Would this be regarded as a good thing, and would it alter the explanation offered by this analysis for the boom-bust cycle?