Nobel Symposium
"Money and Banking"

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Discussion of Barry Eichengreen and Ben Bernanke

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Two papers difficult to discuss (in 15 minutes…)

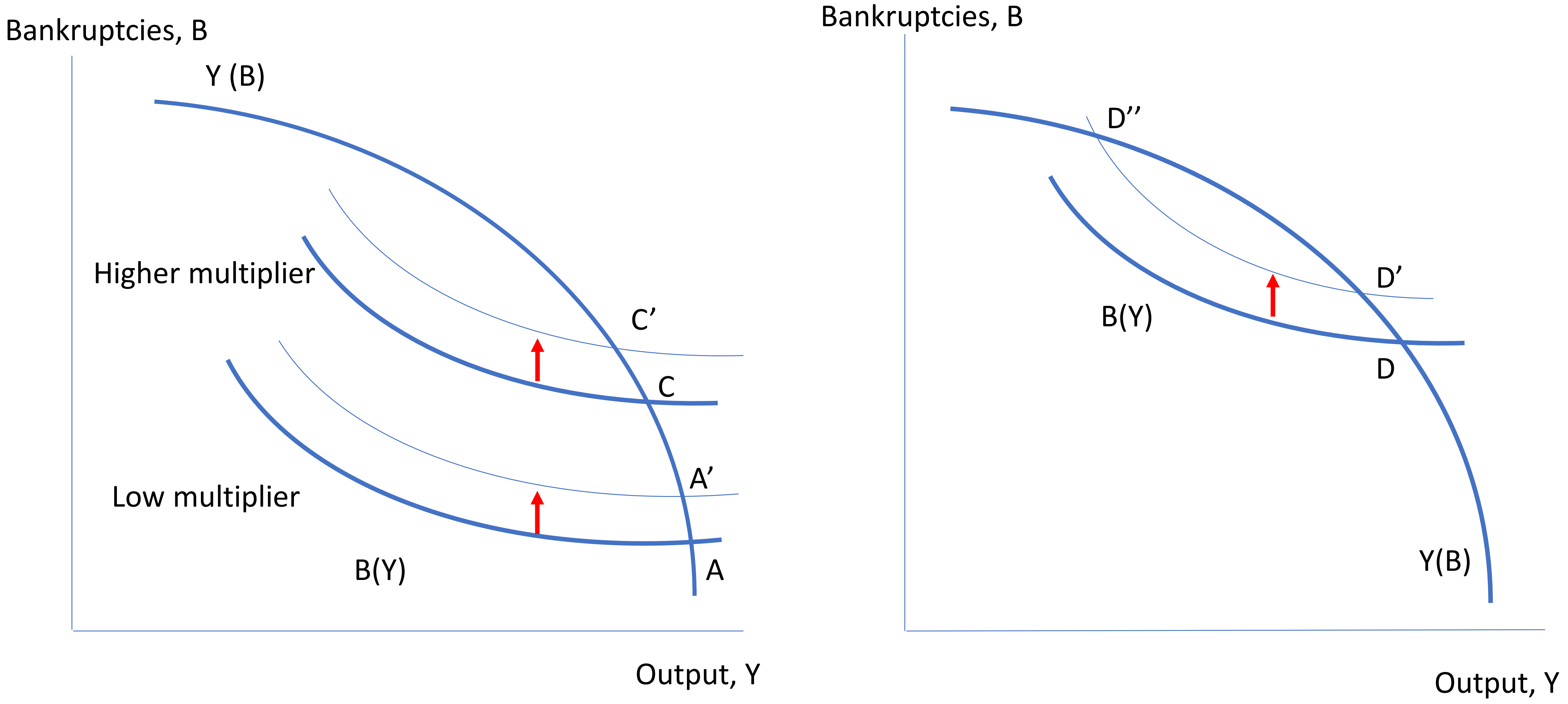
- Barry Eichengreen's ``The global financial crisis and the lesson-drawing problematique"
  - A set of thoughts, based on a great book: ``Hall of mirrors'', comparison of Great Depression and Great recession

- Ben Bernanke's paper. Two parts. A very useful survey. How to discuss a survey? Intriguing empirical work on real effects of the financial crisis.

- Based on both papers, the experience of the Great Depression in US and Europe, the Great Recession in the US and Europe, try to give a picture of the different elements of a financial crisis and macroeconomic effects

- Can think of 5-level scale for financial crises, from mild to acute. Similarities and differences between the four crises?

A quick detour: Multipliers and Multiple Equilibria



High multipliers and multiple equilibria are close cousins.

The five levels

Start from an initial adverse shock to some asset price, housing (US, Spain, Ireland)

Level 1. Borrower balance sheets

- Worse balance sheet, lower valued collateral, less borrowing
- Less borrowing, less spending, lower output, worse balance sheet

- Multipliers: moderate. Depend on initial leverage (housing slump versus hi tech bubble burst)
- Easy to integrate in standard models. Amplification mechanism

Level 2. Lenders' (financial intermediaries) balance sheets

- Worse balance sheet, lower capital, less lending
- Less lending, less spending, lower output, worse balance sheet

- Housing: US, Spain, Ireland. Crossing the ocean: German banks
- Multipliers: higher. Much higher leverage to start.
- Still easy to integrate in standard models. Amplification mechanism

Level 3. Runs on liabilities, sudden stops, rollover crises, interbank market freeze

- Uncertainty (Knightian in part): Solvency or liquidity?
- Run on liabilities, fire sale of assets or worse, less lending
- Less lending, less spending, lower output, worse balance sheet

- Multipliers. High. Multiple equilibria.
- Crucial role. Role of LLR: Great Depression versus Great recession
- Crucial role. Implicit guarantees.

Ben stops at level 3 (OK for the US Great Recession). But, in general, two more levels, sources of amplification or worse.

Level 4. Interactions between the state and financial institutions.

("Doom loops, diabolical loops, deadly embrace")

- Weak bank balance sheets, probability of bailouts
- Probability of bailouts lead to weak public balance sheets
- Weak public balance sheets make bailouts less likely

Related but separate: fiscal multiple equilibria.

- Low interest rates, public debt sustainable
- High interest rates, public debt not sustainable.
- Public debt not sustainable, high interest rates

Strong multipliers. Multiple equilibria.
Depends on fiscal position, resolution process, bonds in banks' balance sheets.

Did not happen in the US Great Depression (bailouts unlikely)
Did not happen in the US Great Recession (solid fiscal position)
Played major role in Euro Great Recession

Level 5. The role of the exchange rate regime.

Flexible rates. Depreciation

- Usual positive effect on domestic demand
- FX liabilities and adverse balance sheet effects.
- Then, back to previous mechanisms.

Fixed rates.

- Limited room to decrease interest rate. Potential constraint on LLR (Barry on Great Depression.)
- Risk of devaluation ("redenomination" risk in the euro zone) Increase in spreads. Back to previous mechanisms.

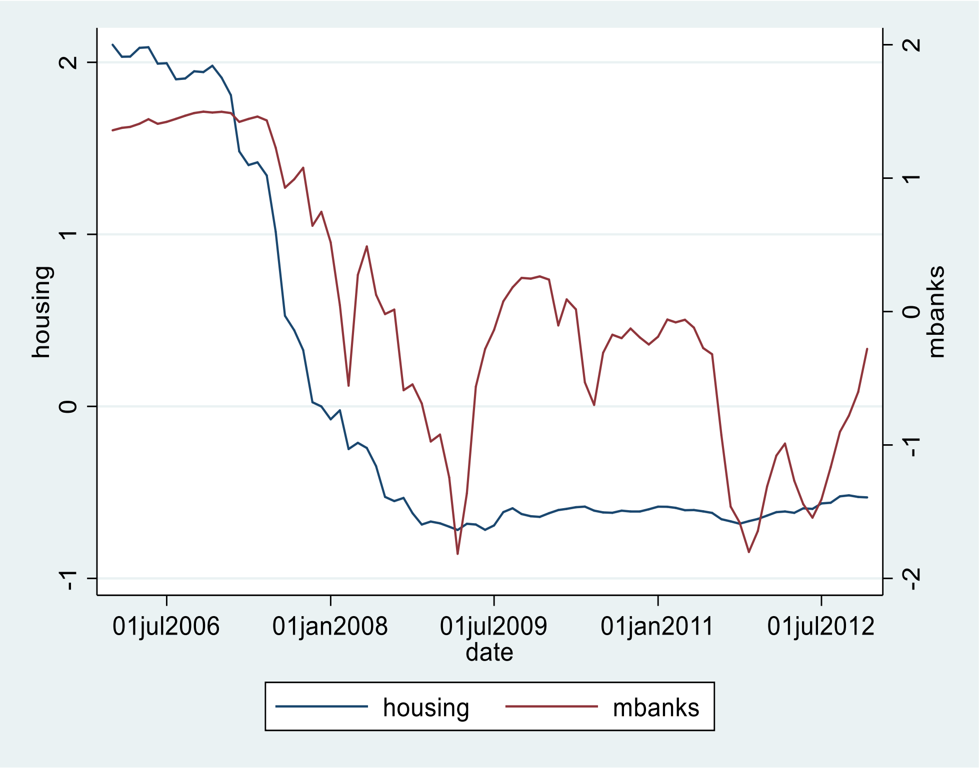
Irrelevant for US Great Recession (safe haven).
Relevant for non US Great Depression
Highly relevant for Euro south in Great Recession.

Policy: Decrease multipliers/prob of multiple equilibria at each level
Keep effect as close to level 1 as feasible.

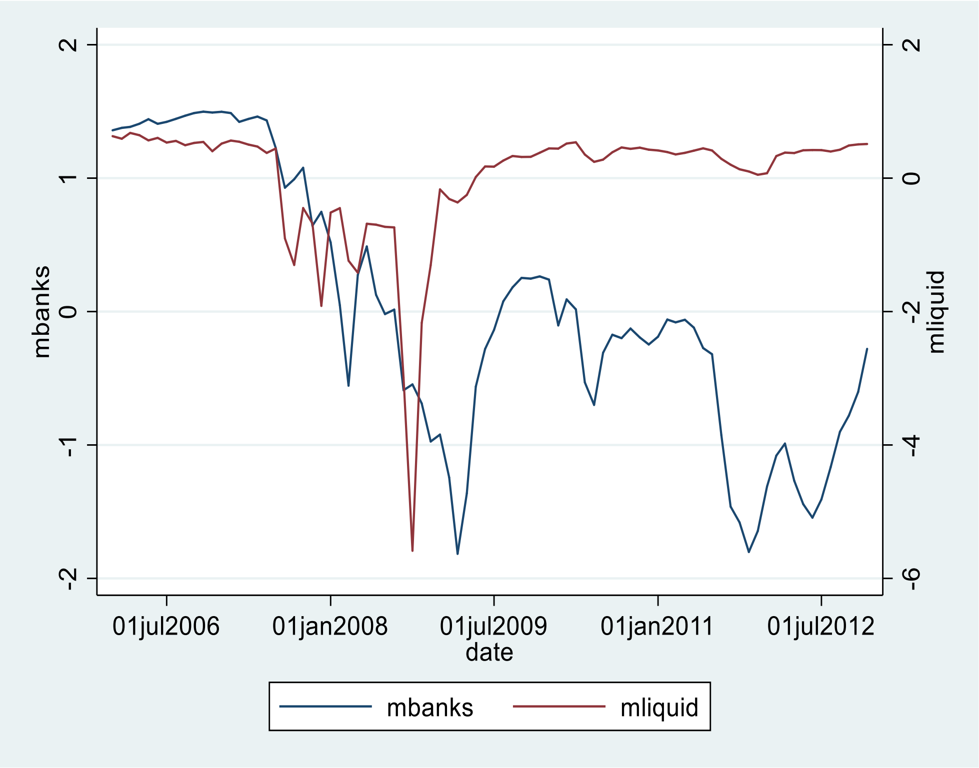
Scope for high multipliers/multiple equilibria. Not DSGE friendly.

Looking at the Great Recession through Bens' four factors

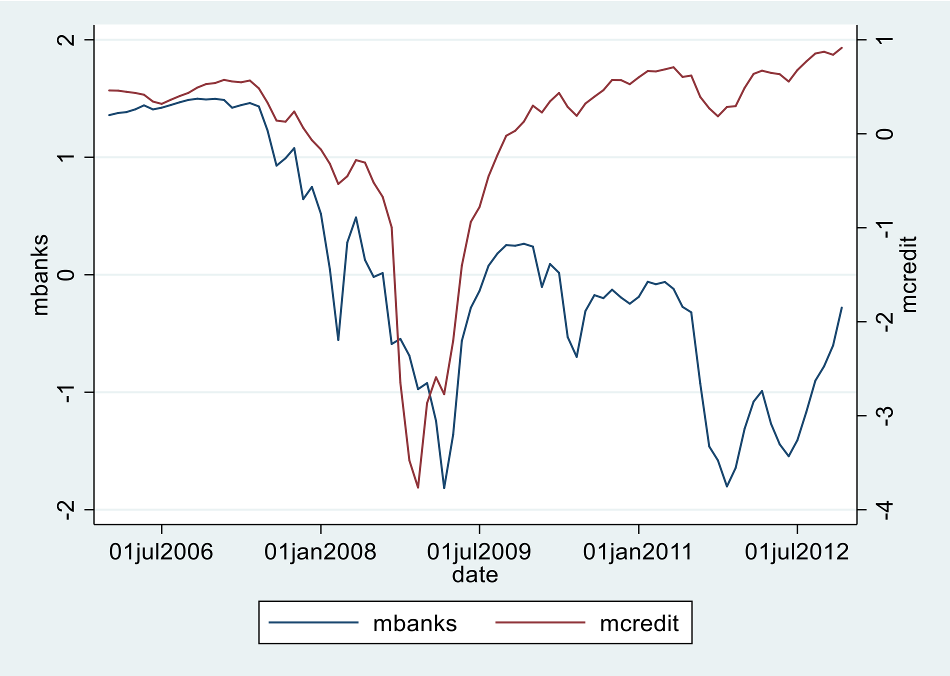
- From the housing bust to banks' health (Levels 1 and 2)



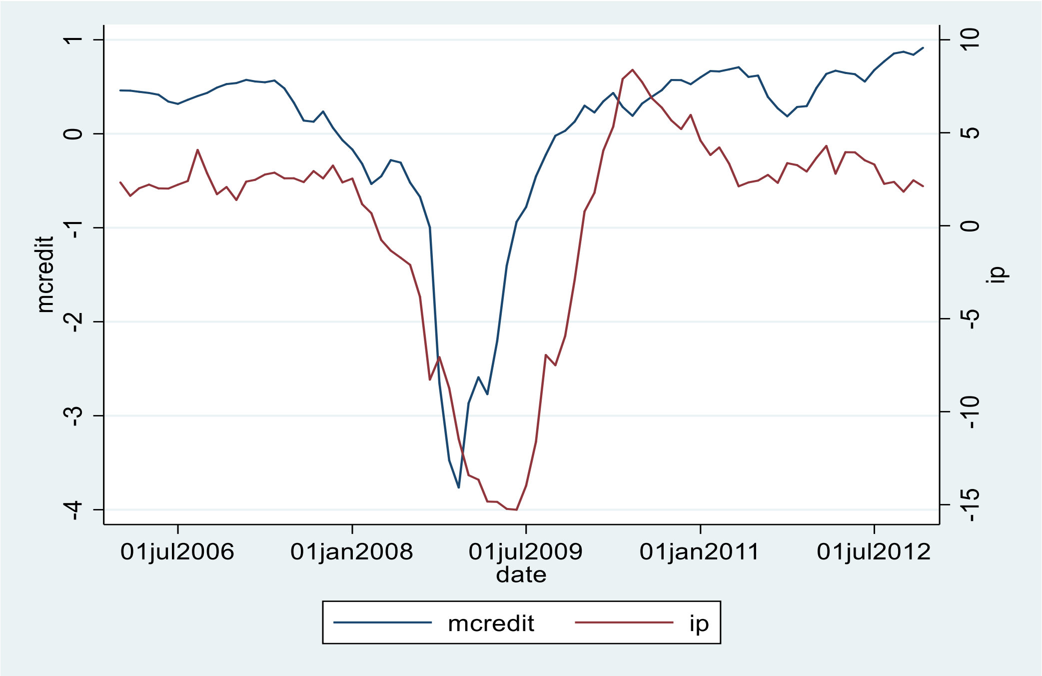
From banks' health to interbank freeze (Level 3, but short because of policy reaction)



From banks to credit
Note the quick recovery of credit, not of banks



From credit to real activity
A very tight fit.



Fascinating facts. Not easily captured by (linear) VARs. I look forward to more empirical work (Brookings Paper?)