

Discussion of Credit Traps Benmelech and Bergman

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My General view

- This is a very nice paper that is simple enough even for me to understand
- I want to briefly compare it to the “Irving Fisher” view of debt-deflation which is highly relevant to the current crisis

What this model is not

- (1) *This is not really a paper about banking.*
Nothing special or unique about banks.
Could replace banks with “bond market investors” without changing anything.
- (2) *This is not really a paper about the Fed.*
Could replace “reserves” with “lump sum transfers to bond market” without changing anything.

What this model is not

(3) *This paper is not about the current crisis*

As the authors clearly state

(4) *This paper doesn't help us understand why firms chose to have high leverage*

We are just endowed in the first period with capital constrained firms.

What this model *is*

It is about how there is a feedback or multiplier effect: more loanable funds (can) lead to higher collateral value and higher investment.

The emphasis on collateral reminds me of Irving Fisher's (1933) Debt – deflation theory

Irving Fisher, 1933

- (1) More Liquidation
- (2) Distress Selling
- (3) Fall in Security Prices
- (4) Reduction in Net Worth
- (4) Increase in Bankruptcies
- (6) Decrease in Construction
- (6) Reduction in Output
- (7) More Gloom
- (7) More Pessimism and Distrust
- (8) Hoarding
- (8) Runs on Banks
- (8) Banks Curtailing Loans for Self-Protection
- (8) Banks Selling Investments
- (8) Bank Failures

- I. (7) *Mild Gloom and Shock to Confidence*
(8) *Slightly Reduced Velocity of Circulation*
(1) *Debt Liquidation*
- II. (9) *Money Interest on Safe Loans Falls*
(9) *But Money Interest on Unsafe Loans Rises*
- III. (2) *Distress Selling*
(7) *More Gloom*
(3) *Fall in Security Prices*
(1) *More Liquidation*
(3) *Fall in Commodity Prices*
- IV. (9) *Real Interest Rises; REAL DEBTS INCREASE*
(7) *More Pessimism and Distrust*
(1) *More Liquidation*
(2) *More Distress Selling*
(8) *More Reduction in Velocity*
- V. (2) *More Distress Selling*
(2) *Contraction of Deposit Currency*
(3) *Further Dollar Enlargement*
- VI. (4) *Reduction in Net Worth*
(4) *Increase in Bankruptcies*
(7) *More Pessimism and Distrust*
(8) *More Slowing in Velocity*
(1) *More Liquidation*
- VII. (5) *Decrease in Profits*
(5) *Increase in Losses*
(7) *Increase in Pessimism*
(8) *Slower Velocity*
(1) *More Liquidation*
(6) *Reduction in Volume of Stock Trading*
- VIII. (6) *Decrease in Construction*
(6) *Reduction in Output*
(6) *Reduction in Trade*
(6) *Unemployment*
(7) *More Pessimism*
- IX. (8) *Hoarding*
- X. (8) *Runs on Banks*
(8) *Banks Curtailing Loans for Self-Protection*
(8) *Banks Selling Investments*
(8) *Bank Failures*
(7) *Distrust Grows*
(8) *More Hoarding*
(1) *More Liquidation*
(2) *More Distress Selling*
(3) *Further Dollar Enlargement*

Questions outside the model

- (A) How did we get to the initial condition in date 0 where there is overleverage and vulnerability to credit disruptions? How might leverage be endogenously too high?
- (B) Does the Fed really have a role? Did the crisis really have anything to do with the Fed?
Seems like in many cases, Fed is invoked as mysterious cause of all events (e.g., the tech stock mania of 1999/2000).

(A) Endogenous over-leverage

“Thus over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money. That is, over-indebtedness may lend importance to over-investment or to over-speculation.

The same is true as to over-confidence. **I fancy that over-confidence seldom does any great harm except when, as, and if, it beguiles its victims into debt.**” - Fisher 1933

(A) Endogenous over-leverage

My own spin on this:

- financial crashes will be rare events.
- Dick Fuld of Lehman didn't deliberately chose to over-leverage, it must have been an expectational error by him.
- “Thus debt-related pessimistic equilibria can only occur if pessimistic equilibria are thought to be low-probability events when financial structure is chosen” Lamont 1995

(B) The Fed and multiple equilibria

- To me, a very clear feature of the 2008 crisis was its “run-on-the-bank” nature.
- Run-on-the-bank = multiple equilibria
- In the current paper, we have different equilibria depending on size of Fed action. Seems more natural just to have regular multiple Nash equilibria depending on beliefs
- Seems to me this run could have happened any time...in 2007, 2006, 2005, or earlier. Its arbitrary

(B) The Fed and multiple equilibria

I doubt that the Fed mechanically caused the crisis, and it is hard to know right now how big a role the Fed or Treasury had in resolving, mechanically.

What is clear is that market participants *believe* the Fed has the power to solve the crisis.

In a world of animal spirits/multiple equilibria, if they believe it to be true, it is true.

Multiple equilibria

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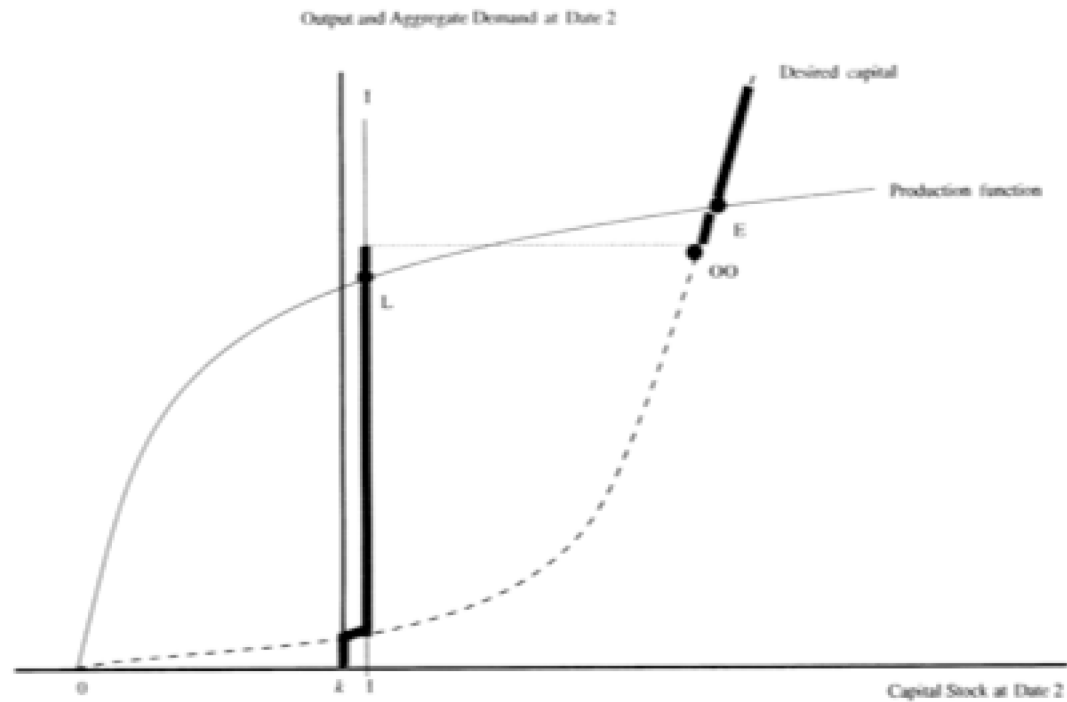


FIGURE 2. FINANCIAL CONSTRAINTS CREATING MULTIPLE EQUILIBRIA

A final note on mass extinction

- Figure 6B of paper: severe credit trap where no lending takes place = great depression
- My own 1995 paper: “One weakness of the model as currently formulated is that it relies too heavily on the possibility of mass bankruptcy.”
- Sadly, the possibility of mass bankruptcy is no longer a “weakness” of models. It is a dose of realism! Not a bug, but a feature!