

Discussion of “Credit Expansion and Credit Misallocation” Alexander Bleck and Xuewen Lin

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Overview

- The paper is part of a growing academic literature that tries to incorporate a financial sector and financial frictions into macroeconomic models thereby creating a more realistic structure for thinking about monetary and fiscal policy.
- The model creates a useful structure for modeling a relationship between credit availability, asset valuations, solvency and asset specificity or financing frictions that differ across sectors. Because credit availability affects asset valuations there is a potential for feedback loops that can lead to inefficient allocation of investment.
- The model equates central bank liquidity with bank credit, and therefore draws potentially misleading conclusions about the source of inefficiency in a financialized economy.

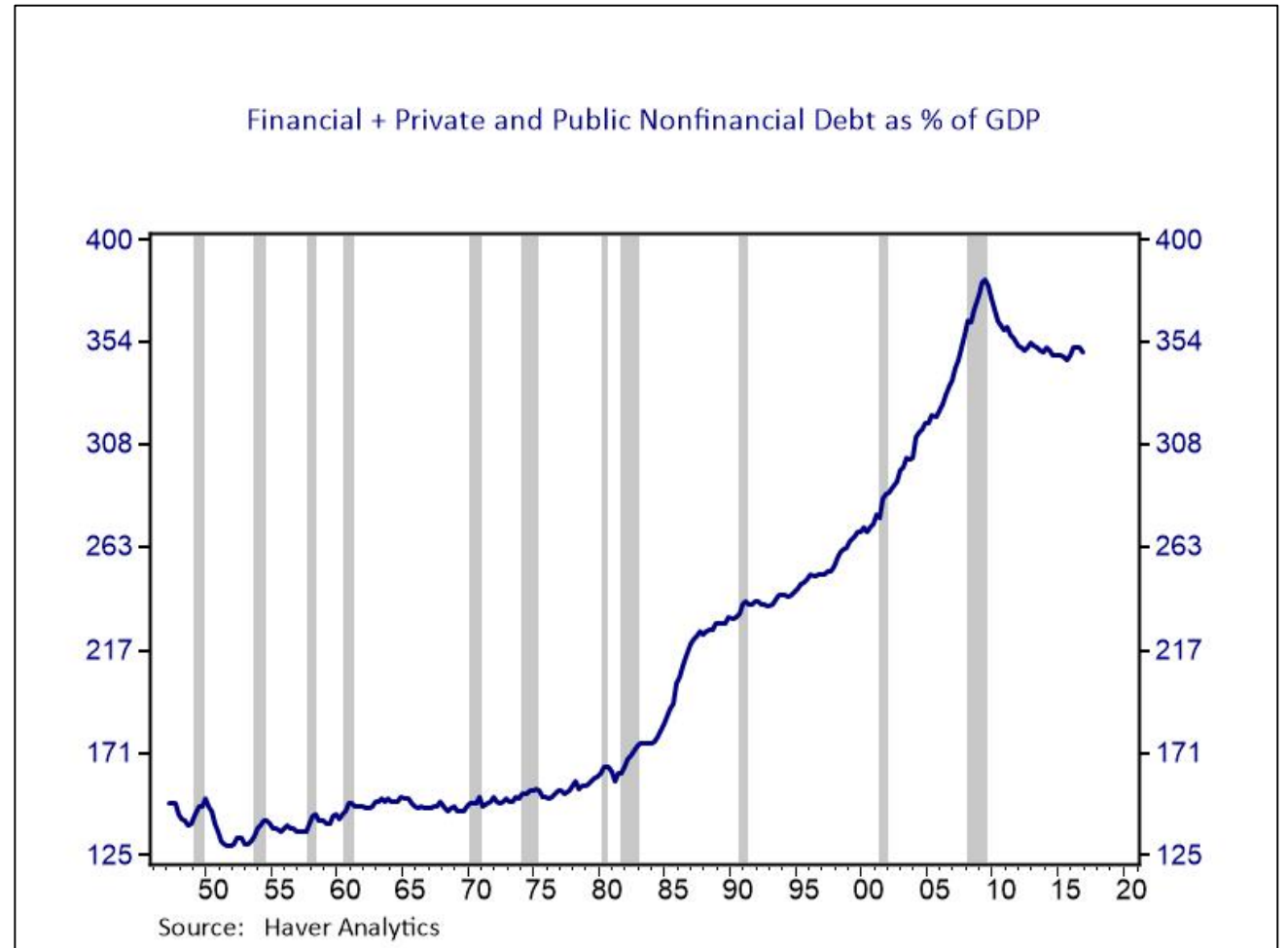
Financialization: When the exchange of goods and services is increasingly facilitated through financial instruments

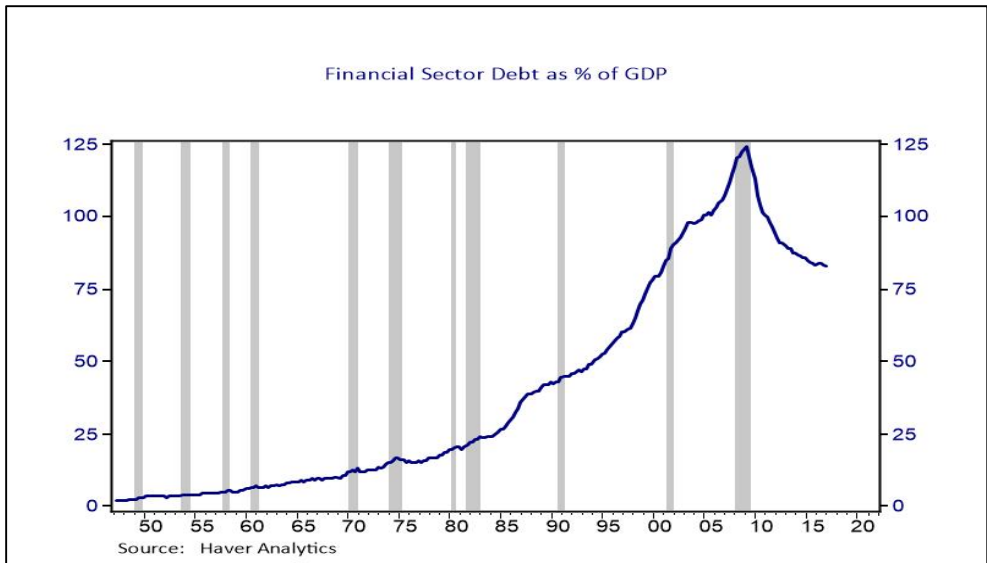
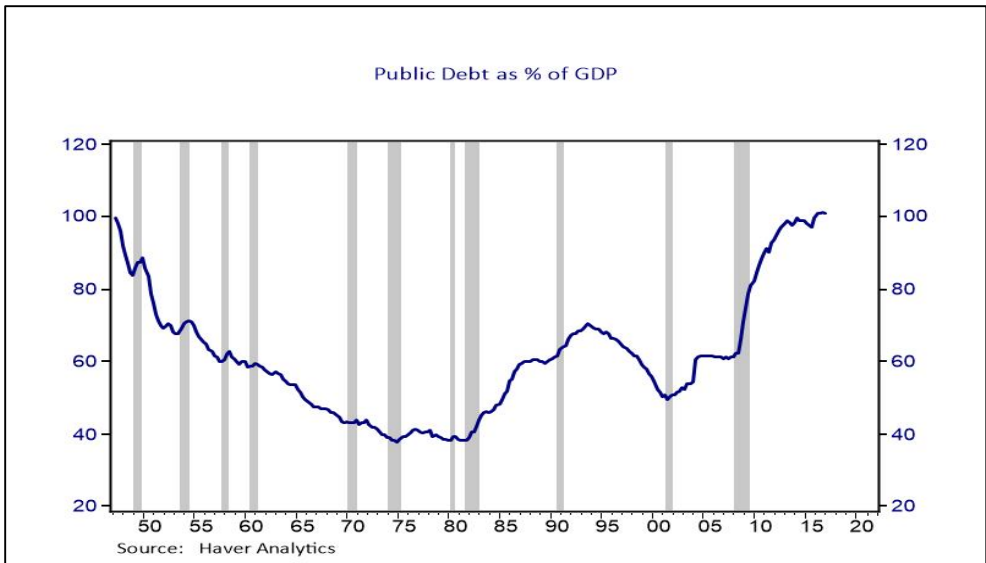
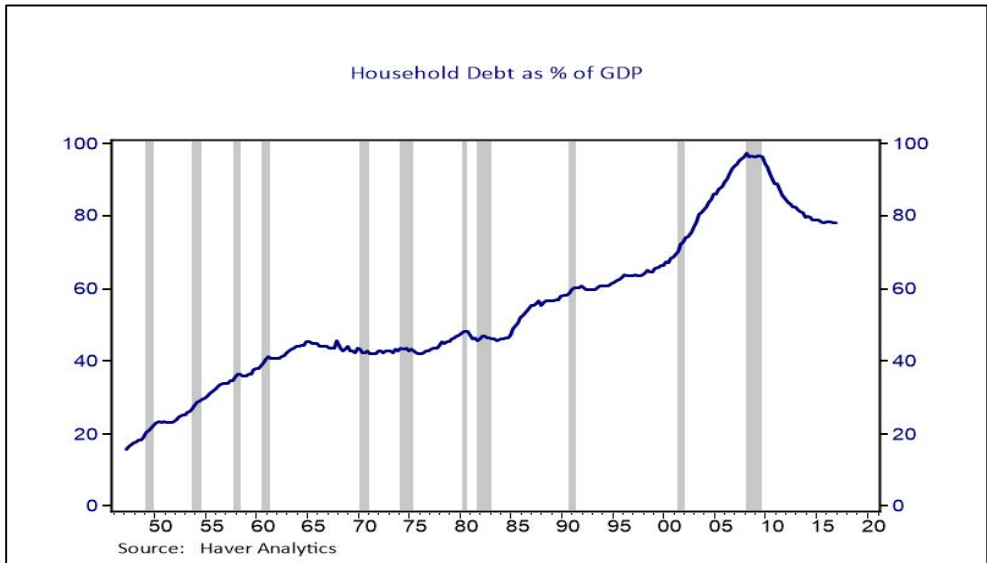
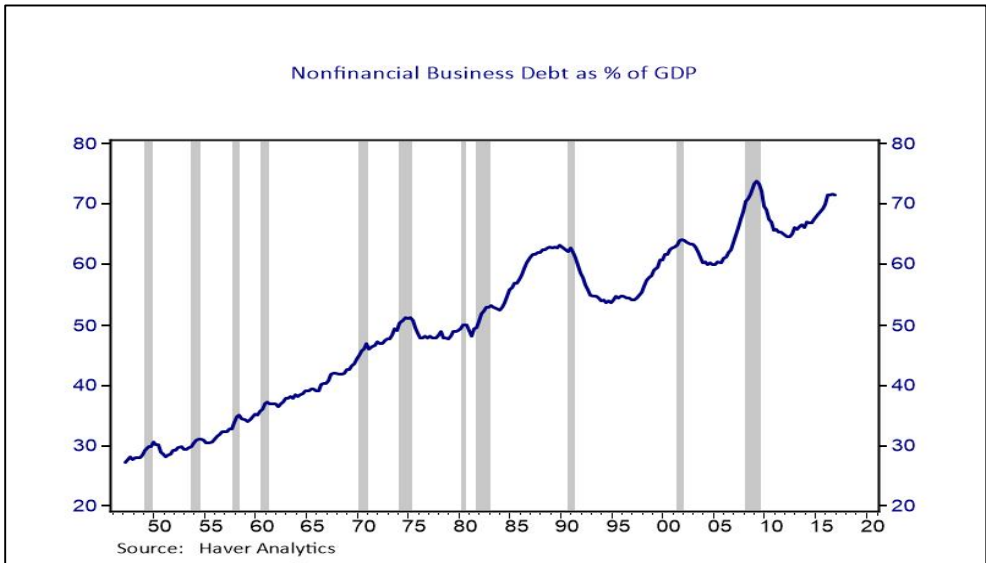
- Financialization increases the ability to exchange goods and services across different currencies, over time, across different states of the world and it increases the ability to borrow against an existing stock of assets.
- It has been associated with rising ratios of debt to GDP globally and with asset valuations that vary more over the business cycle even as the fluctuations in GDP have attenuated until the Great Recession.
- Financialization can amplify the natural volatility that occurs from the speculative process that is a natural cornerstone to investing.
 - When investing “the American is not attaching his hopes to the investment's long-term expected return, but rather to a favorable change in its short-term valuation; i.e., he is a speculator. Now, speculators may do little or no harm when they are only bubbles on a steady stream of long-term investors; but they can be seriously harmful when long-term investors become the bubble on a whirlpool of speculators. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.”

Keynes, Chapter 12, The General Theory of Employment, Interest and Money

Drivers of Financialization

- Floating currency regimes after the collapse of Bretton Woods.
- Technology, globalization
- Rise of China and entry into the global trading system.
- Deregulation of the financial system and complacency of regulators in the efficiency of markets





The Fed did not inject liquidity throughout the four decades of financialization until the crisis



Getting to the Heart of Credit Dynamics

- The paper usefully creates a structure whereby access to credit can vary owing to differing degrees of asset specificity across sectors, and across states of the world.
- However by equating monetary policy actions to bank credit, the paper ascribes a causal role to the central bank in producing inefficiencies through “market-based monetary policy” when the central bank acted owing to a build up of existing inefficiencies.
 - The mechanism for perpetuating inefficiencies also seems implausible: who is the sector driving up rates with excessive borrowing in a deleveraging cycle?
- There is an important distinction between liquidity and credit. The extension of credit includes a contractual obligation for repayment. Liquidity is the ability to transact. In the crisis Fed first used its unique ability to print money to extend credit thereby enhancing liquidity, Bagehot style. QE boosts asset prices without the creation of credit, which has some unsung advantages over fiscal policy.

What Should Monetary Policy Look Like in a Financialized World?

- There has been a greater focus on regulatory oversight
- Finding the right role for QE/balance sheet policy outside crises

