Financial market frictions in a model of the Euro area

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A R T I C L E   I N F O

Article history:
Accepted 20 June 2012

JEL classification:
C11
C32
E32
E37

Keywords:
Financial frictions
Euro area
DSGE modeling
Bayesian estimation
Simulation
Decompositions

A B S T R A C T

We build a model of the euro area incorporating financial market frictions at the level of firms and households. Entrepreneurs borrow from financial intermediaries in order to purchase business capital, in the spirit of the “financial accelerator” literature. We also introduce two types of households that differ in their degree of time preference. All households have preferences for housing services. The impatient households are faced with a collateral constraint that is a function of the value of their housing stock. Our aim is to provide a unified framework for policy analysis that emphasizes financial market frictions alongside the more traditional model channels. The model is estimated by Bayesian methods using euro area aggregate data and model properties are illustrated with simulation and conditional variance and historical shock decomposition.

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1. Introduction

The global financial crisis which began around the turn of 2007/2008 has — amongst other things — prompted a re-evaluation of modeling strategies as regards financial linkages. It has long been known that financial markets are and were highly imperfect. This reflects information asymmetries between lenders and borrowers, costly verification of financial contracts, and the possibilities of bankruptcies and contagions, etc. Consequently, a feature of financial markets is that lenders tend to demand a premium (or spread) over risk-free interest rates as compensation against such uncertainties. Premia aside, borrowers may also be restricted in the absolute amount of funds available to them, for example as in mortgage loans.

The strength of such “financial frictions” and the soundness of the financial system have implications for how central banks conduct monetary policy and assess inflationary pressures and risks. The widening of spreads and deterioration in private lending from late 2007 onwards in many countries prompted a number of central banks to loosen monetary policy and engage in various forms of enhanced credit support, reflecting concerns that tensions in financial markets would spill-over to the wider economy.

Nevertheless, many policy models largely assume frictionless financial markets (with a few notable exceptions, Christiano et al. (2003)). This reflects, to some degree, likely academic and empirical controversy as to the importance of financial channels. Some analysis stress them as a key amplifier and source of business-cycle fluctuations (see e.g. Bernanke et al. (1999), hereafter BGG) whilst others suggest their impact may be relatively minor (see Meier and Mueller (2006)) or strongest during extreme and particular financial distress such as the Great Depression, the Asian Crisis (see Gertler et al. (2007)) as well as presumably the most recent global financial turbulence.

Notwithstanding, our work builds on recent attempts to model the euro area using the current generation of micro-founded Dynamics Stochastic General Equilibrium (DSGE) models, following Smets and Wouters (2003) and the “New Area Wide Model” (NAWM) of Christoffel et al. (2008), but supplemented with a number of standard financial frictions. For instance, in its current state, the NAWM emphasizes international trade channels by modeling the euro area (EA) as a small open economy vis-a-vis the rest of the world. Financial markets, though, are modeled in relatively standard way, except that trade in domestic bonds and international bond takes place at an exogenous premium. Recent episodes of financial market turbulence have increased the demand for general equilibrium models that can account for the interaction between these markets, inflation and the real economy. Central banks’ staff, for example, are increasingly confronted with questions concerning...
the interaction between asset prices, inflation monetary policy. Our work is a first step in the direction of putting existing and well-known euro area models in the position of being able to address these type of questions.

We extend the baseline model by introducing financial market frictions that can give rise to an interaction between financial market variables and the rest of the economy. There are two common ways of modeling financial constraints: i) via limited enforceability and collateralised debt (Iacoviello (2005)) and ii) via costly state verification and default risk (e.g. BGG). Here we use both. The first is used to model the financial constraints faced by households. The second is used to model the constraint faced by firms.

Both financing schemes generate a link between the net worth of agents and their creditworthiness, and so would be equally suitable to describe both household finance and firms finance. Nevertheless the collateral constraint model generates quantitative rationing leaving the cost of funds at the risk-less rate level. The costly-state-verification model, instead does not limit the level of debt, but generates instead a model for Canada with borrowing constraints for both households.

We show that the introduction of financial market frictions in the typical DSGE framework can provide important insights on the response of the economy to financial market shocks, although it need not alter dramatically the predictions on the response of the economy to non-financial shocks. Furthermore, our extensions allow us to explain the effects of non-financial shocks on important financial variables as external-finance premia, house prices and residential investment.

The paper proceeds as follows. Section 2 describes the model. Section 3 takes a general look at the data and underlying calibration and shock structure of the model. We then examine, in Section 4, the Bayesian estimation of variants of the model. This is followed by an examination of the model properties: simulation exercises; stylised facts matching; conditional variance and historical decompositions. Finally, we conclude.

2. The model

The following sections describe the formal representation of the model.

2.1. Households

The population consists of an infinite number of households, which mass is normalised to one. A fraction \( \mathbf{p} \) are patient households, the rest being impatient. The former type is denoted with subscript 1, the second with subscript 2, if not otherwise stated.

2.1.1. Patient households

Patient households solve the following program:

\[
\max_{C_1,t, H_1,t,k, r_1,t,k, b_{1,t,k}, w_{1,t}, d_{1,t}^e} \mathbb{E}_t \sum_{k=0}^{\infty} \left( \beta_1 C_{1,t+k} \right)^{\gamma_1} \mathbb{U} \left( C_{1,t+k} - \kappa C_{1,t+k-1} - \kappa H_{1,t+k} - N_{1,t+k} \right)
\]

subject to

\[
\begin{align}
(1 + \tau^e) C_{1,t} &+ D_{1,t}^e L_t + \left( \frac{R^B}{R^C} \right) - B_{1,t-1} \frac{1}{P_{C,t}} + (R^C(1 - \gamma - \kappa)(S_{1,t} B_{1,t-1}))^{-1} \frac{S_{C,t}}{P_{C,t}} B_{1,t-1} \nonumber \\
&+ \frac{\Pi_{Z,t} + \Phi_{2}}{P_{C,t}} - \frac{B_{1,t} + S_{1,t} B_{1,t-1}}{P_{C,t}} = -q_{1,t} H_{1,t} + q_{1,t} \left( 1 - \delta_{1} \right) H_{1,t-1} \nonumber \\
&+ \left( 1 + R_{DB}^{\text{OH}} \right) D_{1,t}^{\text{OH}} - D_{1,t}^e + \left( 1 + R_{DB}^{\text{OH}} \right) D_{1,t-1}^{\text{OH}} - \frac{D_{1,t}}{P_{C,t}} \Omega_t \nonumber \\
&+ (1 - \tau^W - \tau^C) W_{1,t}^L L_t + \frac{Q_{L,t}}{P_{C,t}} - \frac{Q_{B,t} K_{1,t}}{P_{C,t}} + (1 - \gamma_1) (T_{1,t} - T_{1,t}^C) \nonumber \\
\end{align}
\]

and to

\[
K_{1,t+1} = (1 - \delta) K_t + \frac{\xi}{1 - \gamma_1} \left( 1 - \Gamma_1 \left( \frac{H_t}{C_{1,t}} \right) \right) H_t
\]

where the instantaneous utility function is defined as

\[
U \left( C_{1,t} - \kappa C_{1,t-1}, H_{1,t}, N_{1,t} \right) \equiv \left( 1 - \frac{\kappa}{C_{1,t}} \right) \ln \left( C_{1,t} - \kappa C_{1,t-1} \right) + J_{1,t} \ln H_{1,t} - \frac{1}{1 - \gamma_1} N_{1,t}^{1 - \gamma_1}
\]

and where \( \delta \) is the capital depreciation rate. \( \hat{\beta}_1 \) is the households time preference parameter, \( \kappa \) is the long-run growth rate of consumption (identical to the long-run growth rate of technology), \( C_t \) is a CES index of domestic and foreign goods, described later. \( C_{1,t} \) is the aggregate consumption of patient households (with habit-persistence parameter \( \kappa \)). \( P_{C,t} \) is the stock of housing, \( N_{1,t} \) is labor supply (with elasticity \( \delta \)), \( \delta \) is investment, \( K_t \) is capital, \( B_t \) is domestic bonds, \( B_{DB} \) is foreign bonds, \( S_t \) is the nominal exchange rate, \( D_{1,t} \) is deposits at the Building Societies, \( D_{1,t}^e \) is deposits at the Banks, \( \Xi_t \) and \( \Phi_{t} \) are profits reaped by firms and banks to households including rent of land to residential investment, \( W_{1,t} \) is nominal wages, \( q_{1,t} \) is the price of houses in terms of households consumption units, \( R_{DB} \) is a premium paid on foreign bonds transactions (proportional to the size of foreign borrowing), \( \Gamma_1 \) is the investment adjustment cost, \( P_{C,t} \) is the consumer price index, \( P_{B,t} \) is the price of investment goods, \( \tau^W \) is the policy rate (return on domestic bonds), \( \tau^C \) is the return on foreign bonds, \( \tau^W \) is the return on deposits at the Banks, \( Q_{B,t} \) is the price of capital, \( \tau^W \) is a consumption tax, \( \tau^C \) is a labor income tax, \( \tau^W \) is an additional payroll tax, \( \tau^W \) is a lump-sum tax, \( \tau^W \) is a risk premium shock, \( \gamma_1 \) is an investment specific shock, \( \tau^W \) is a housing preference shock, \( \gamma_1 \) are the entrepreneurs survival shock discussed further below, \( T_{1,t} \) is a transfer from exiting entrepreneurs to households, \( T_{1,t}^C \) is a transfer from households to new entrepreneurs (start-ups), finally \( \Omega_t \) is a transfer to household consisting of the monitoring costs of the net worth of defaulting firms.\(^4\)

2.1.2. First order conditions

For simplicity re-define \( \beta_1 \equiv \beta_1 \kappa \). The FOCs to the household problem are:

\[
B_{1,t+1} : \lambda^P_t = \beta_1 E_t \left[ \lambda^P_{t+1} \frac{R_{t+1}}{P_{C,t+1}} \right] \quad (3a)
\]

\[
D_{1,t}^e : \lambda^P_t = \beta_1 E_t \left[ \lambda^P_{t+1} \left( 1 + R_{DB}^{\text{OH}} \right) \right] \quad (3b)
\]

\(^2\) We assume that habit formation is “external” to the household but “internal” to the household type. Notice also that we are assuming log-preferences in consumption (cum habits) and in housing.

\(^3\) See also Christoffel et al. (2008) on assumptions concerning taxes.

\(^4\) We can think of the default costs as a tax transferred to households.
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