

Accepted Manuscript

Hard vs. Soft Financial Constraints: Implications for the Effects of a Credit Crunch

Cristian Alonso

PII: S0164-0704(18)30226-X
DOI: <https://doi.org/10.1016/j.jmacro.2018.09.001>
Reference: JMACRO 3060



To appear in: *Journal of Macroeconomics*

Received date: 22 May 2018
Revised date: 12 August 2018
Accepted date: 3 September 2018

Please cite this article as: Cristian Alonso, Hard vs. Soft Financial Constraints: Implications for the Effects of a Credit Crunch, *Journal of Macroeconomics* (2018), doi: <https://doi.org/10.1016/j.jmacro.2018.09.001>

This is a PDF file of an unedited manuscript that has been accepted for publication. As a service to our customers we are providing this early version of the manuscript. The manuscript will undergo copyediting, typesetting, and review of the resulting proof before it is published in its final form. Please note that during the production process errors may be discovered which could affect the content, and all legal disclaimers that apply to the journal pertain.

Hard vs. Soft Financial Constraints: Implications for the Effects of a Credit Crunch[☆]

Cristian Alonso

Princeton University, Julis Romo Rabinowitz Building, Princeton, NJ 08544, United States of America.

Abstract

In the aftermath of the Great Recession, understanding how households' consumption responds to a credit crunch has been a central goal of macroeconomics. Most of the recent research has explored this question using a "hard constraint" modeling device, where households can borrow at the risk-free rate only up to an exogenous amount. An alternative, and more realistic, way to model financial frictions is to allow households to borrow as much as they want but at an interest rate that depends on the level of debt. I refer to the latter as the "soft constraint" model. In a Standard Incomplete Markets framework with heterogeneous agents, I calibrate two economies differing only in the type of financial constraint that households face and I show that a credit crunch in the hard constraint economy (i.e. decrease in the exogenous borrowing limit) produces a drop in consumption significantly more severe than an equivalent crunch in the soft constraint version (i.e. increase in the borrowing interest rate). I conclude that the quantitative consequences of a credit crunch largely depend on the modeling approach.

Keywords: Credit Crunch, Borrowing Constraints, Consumption
JEL: E21, E44

1. Introduction

After the Great Recession, research has flourished in an attempt to enhance our understanding of the effects of a credit crunch, i.e. a decrease in the availability of credit in the economy, on real variables such as consumption and employment.¹ Most recent work has modeled credit conditions as a hard borrowing constraint, i.e. an exogenous limit on the amount that households can borrow. In this context, a credit crunch is defined as a reduction in the borrowing limit, which forces households to reduce their consumption until they satisfy the new, lower limit. An alternative approach is to assume what I will call a soft borrowing constraint. In this setup, households can borrow as much as they want, up to their natural borrowing limit, but at an interest rate that is higher than the saving rate and potentially increases with the amount borrowed. In this context, a credit crunch is modeled as an increase in the borrowing interest rate. Both models can easily accommodate loose financial conditions (loose borrowing limit, low borrowing rate) as well as tight ones (tight borrowing limit, high borrowing rate). In this paper, I demonstrate that the choice to describe credit market conditions in terms of hard or soft constraints is not inconsequential. Rather it has important implications for inference on the effects of a credit crunch in the macroeconomy.

I compare these two alternative specifications of the financial constraints in a life-cycle Standard Incomplete Markets framework with heterogeneous agents in partial equilibrium. Consumers receive a stochastic and idiosyncratic income shock every period and decide how much to consume and how much to save or

[☆]This research did not receive any specific grant from funding agencies in the public, commercial, or not-for-profit sectors.

Email address: calonso@princeton.edu (Cristian Alonso)

¹Eggertsson and Krugman (2012), Guerrieri and Lorenzoni (2017), Buera and Moll (2015), Jones et al. (2017), Huo and Ríos-Rull (2016), and Justiniano et al. (2015)

Download English Version:

<https://daneshyari.com/en/article/11031332>

Download Persian Version:

<https://daneshyari.com/article/11031332>

[Daneshyari.com](https://daneshyari.com)