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Debt-deflation, financial market stress and regime change – Evidence from Europe using MRVAR*

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Abstract

Since the economic meltdown of 2008-9 many euro area countries have experienced disinflation, and even deflation, in a period with large debt overhang, creating the conditions for continuing financial market stress. As disinflation and deflation push up the real interest rate, while growth and income declines, the leveraging problem becomes more severe and the economy risks shifting into a regime with high insolvency risk, high financial stress, rising credit spreads, possibly accompanied by strong adverse macroeconomic feedback loops. Investigating the consequences of those magnifying feedback loops, given the debt-deflation, we demonstrate the possibility of unstable dynamics and downward spirals in the presence of regime-dependent macro feedback loops, using a theoretical model with decentralized matching mechanisms on both labor and financial markets. To explore the amplifying linkages between deflation, output, labor and financial markets, we employ a new solution procedure called Non-linear Model Predictive Control (NMPC) to solve our models variants for out-of-steady-state dynamics. We apply a four variable Multi-Regime VAR (MRVAR) model with regime dependent (generalized) impulse-response functions (GIRFs) to study deflationary and financial risk drivers empirically for Southern and Northern EU countries. New measures for financial risk drivers are employed and GIRFs for output, inflation rates, interest rates and financial stress are explored. The econometric results of the MRVAR are roughly in line with the theoretical regime change model.

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