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Credit Booms, Debt Overhang and Secular Stagnation

Gerhard Illing* Yoshiyasu Ono† Matthias Schlegl‡

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Abstract

Why do economies fall into prolonged periods of economic stagnation, particularly in the aftermath of credit booms? We study the interactions between household debt, liquidity and asset prices in a model of persistent demand shortage. We show that financially more deregulated economies are more likely to experience persistent stagnation. Credit booms or asset price booms mask this structural aggregate demand deficiency. However, the resulting debt overhang permanently depresses spending in the long run. Hence, the contractionary long run effects of relaxing lending standards are the opposite of their expansionary short run effects. These findings are in line with the macroeconomic developments in Japan during its lost decades and other advanced economies before and during the Great Recession.

Keywords: Secular Stagnation; Aggregate Demand Deficiency; Liquidity Preferences; Credit Booms; Debt Overhang

JEL Classification: E13, E21, E32, E41, E51

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