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The role of cognitive limitations and heterogeneous expectations for aggregate production and credit cycle

Paul De Grauwe and Eddie Gerba*

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The behavioural model of De Grauwe and Macchiarelli (2015) is extended to include financial frictions on the (aggregate) supply side. The result is a tight and sustained feedback loop between animal spirits on one hand, and supply of credit, capital purchase and production on the other. During phases of optimism, credit is abundant, access to production capital is easy, the cash-in-advance constraint is lax, risks are undervalued, and production is booming. Upon reversal in market sentiment, the contraction is quick and deep. Moreover, the model is capable of replicating the stylized fact of a long and sustained simultaneous growth in credit, production and asset prices observed in the US since mid 1990's. Lastly, the behavioural model does a decent job in matching US data including multiple supply-side relations such as capital-firm credit and inflation-interest rate.

Keywords: Supply-side, beliefs, financial frictions, model validation
JEL: B41, C63, C68, E22, E23, E37

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