Abstract

This paper documents a dramatic post-Lehman slowdown in the rate of growth of US banking credit and in net new bond issues in spite of a huge accumulation of banks’ reserves at the Fed. Appealing to results in a theoretical background paper (attached) the credit arrest in the immediate aftermath of Lehman’s collapse is explained in terms of a short term shift in banks’ and bond holders portfolios due to an increase in bailout uncertainty triggered by the Lehman event. The strong persistence of this phenomenon is explained in terms of an increased probabilistic awareness to low bailout probabilities (or, equivalently an increase in uncertainty aversion) within a multiple priors
framework. This point of view explains why, in spite of a huge expansion of the monetary base, inflation has been so low since Lehman’s collapse.

Since that event cumulative base money in the US expanded at a rate similar to the cumulative rate of increase of base money through more than half of the post WWI German hyperinflation. Between September 2008 and September 2014 cumulative inflation in the US has been about twelve percent while the cumulative rate of inflation following the same base money expansion in Germany led to a twenty-four-fold cumulative increase in the price level. An important reason for this dramatic difference is that in the US today the Fed’s high powered monetary expansion is not translated into credit and new purchases. By contrast in post WWI Germany the monetary expansion was immediately used by government to purchase goods and services. This comparison has important implications for the timing and dosage of exit strategies. In particular it implies that mopping up of liquidity should be directly related to future accelerations in banking credit and in net new bond issues.

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