Discussion of "The Great Escape" by Del Negro, Eggertson, Ferrero, Kiyotaki

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Summary

- How to make the share of liquid assets in the economy have real effects? By tying firms' financing constraints, and hence investment possibilities, to resaleability.
- Once liquidity has real effects, can model policy tools other than interest rate.
- When the ZLB binds, such liquidity policies can have large real effects (similar to conclusions about fiscal policies).
- If duration of resaleability shock is uncertain, liquidity provision early on is very important: If shock lasts long, get huge payoffs.

A lot to like about the paper

- Careful modeling of how liquidity provisions by the monetary authority affect real economy.
- Specification of a rule for liquidity provision (26) rather than as exogenous intervention.

Outline of comments

1. Assumptions about expectations formation when ZLB binds and the effects of interventions
2. Liquidity and default risk
3. Lessons for euro area?

What happens at the ZLB without intervention?

- Is everything working through deflationary spiral as in "paradox of thrift," CER? Is this realistic?
- Can we model well-anchored expectations, then rerun shock?
- Think more about the difference between the scenario without intervention (Fig. 7) and the Great Depression: Germany 2009 vs. U.S. 1929-33.

Liquidity and default risk

- Standard assumption in DSGE models: All debt is one-period. Hence "liquidity" in the model is equivalent to "ability to fund investment".
- Private securities all equity, shock does not affect expected future payoffs, no notion of default in the model. Hence clear separation of illiquidity from insolvency.
- When resaleability falls, Tobin's q rises.
- Eisfeldt: Liquidity linked to average quality of assets on sale.

How to think about this model in the euro area?

- In DEFK, government has unlimited ability to create “liquid,” i.e. default-risk-free assets.
- But backing of government liabilities depends on ultimate payoffs from risky assets it purchased. If source of the shock is deterioration of expected future payoffs, government creation of liquidity may be limited by the need to raise primary surplus later.