New Keynesian Models and Financial Frictions

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Background

- Much has happened since 2008.

- Great Recession is a time of broad-based reduction in capital and labor utilization across a wide range of economic sectors.

- Most explanations identify a decline in demand as the proximate cause:
  - Deleveraging households reduce their spending.
  - Cash-strapped governments cut back on spending.
  - Problems in financial sector cause agents who rely on intermediation to cut back on spending.

- But, in economic models with efficiently functioning markets (e.g., real business cycle models), a cut in spending by one group of people does not lead to a substantial decline in *aggregate* spending, i.e., a Great Recession.
  - In RBC model, deleveraging by some households leads to a consumption boom by the people they owe money to.
  - Cut-back in government resource utilization leads to an expansion of resource utilization by private sector.
  - Cut-back in intermediation-intensive activities leads to an expansion in other activities.

Background

- The possibility that spending by a subset of agents could lead to a general decline in spending has helped to increase interest in models with price and wage frictions.
    - Example is the ‘New Keynesian’ model, which assigns a central importance to the possibility that aggregate demand failure can occur because of market inefficiencies.
- Concerns about the financial sector as a source of dysfunction
    - led to huge increase in interest in learning how to integrate financial frictions into models.
    - Implementation of unconventional monetary policies gave rise to an interest in understanding how they work at a conceptual level.

Outline

- Review the foundations of New Keynesian models.
  - Policy implications
    - Rationale for the Taylor principle, and circumstances when it can go awry (working capital, news shocks).
    - Ramsey-optimal policy.
- Costly state verification financial frictions (BGG)
  - Detailed microeconomic analysis.
  - Integrating the frictions into dynamic models.
    - Neoclassical growth (i.e., RBC without labor) model.
    - New Keynesian model.
- Models of banking and unconventional monetary policy.
  - Running away model (Gertler-Karadi, Gertler-Kiyotaki)
  - Hidden effort model .
- We only have time to review a few of the most influential recent models of financial frictions.
  - However, I will stress technique in addition to substance.
  - This should help when you study (and create!) other models.