Thoughts on Importance of Our Foreclosure Paper

→ Suppose that initially $10 of capital supports $100 in loans (leverage 10:1)

assets		liabilities	
loans	100	100	deposits
reserves	10	10	capital
	110	110	

→ now suppose $5 loss on loans

→ consequence: $5 of capital supports $95 in loans (leverage 19:1)

assets		liabilities	
loans	95	100	deposits
reserves	10	5	capital
	105	105	

→ bank must either raise capital or reduce loans

→ banks reluctant to raise capital, so suppose they reduce loans (to $50)

assets		liabilities	
loans	50	55	deposits
reserves	10	5	capital
	60	60	

→ effect is similar to that of enormous monetary contraction ⟹ economic depression

→ if we can find a way to reduce bank losses our economy will recover faster

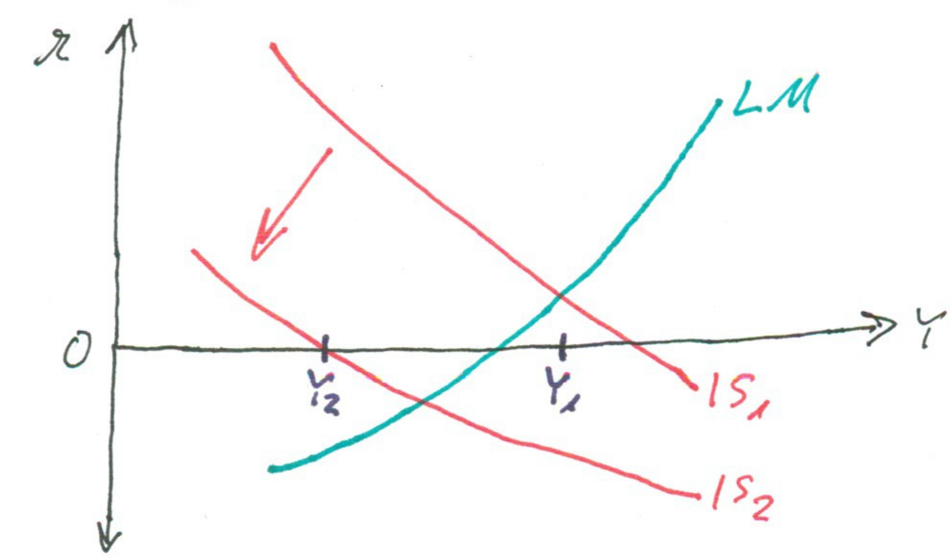
→ effect on bank balance sheets is similar to that of monetary contraction (i.e. large decrease in money supply)

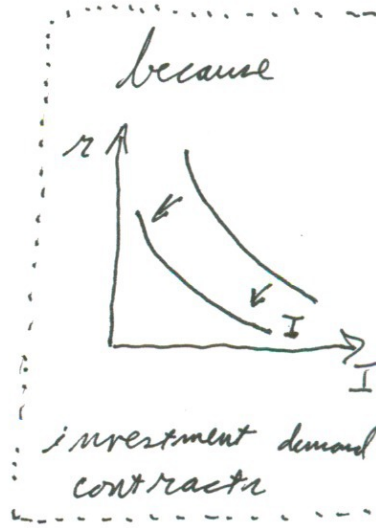
→ but the macroeconomic effects are very different

→ recession triggered by unprofitable investments + decrease in economic activity causes investment demand to contract

→ result is $\boxed{\text{contraction of IS curve}}$

→ if contraction of IS curve is large enough monetary stimulus will be ineffective





→ because interest rates cannot go below zero the economy is stuck at Y_2

- monetary expansion (i.e. $\overrightarrow{LM}$) will not increase output
- fiscal policy extraordinarily effective because investment not "crowded out" by fiscal stimulus