A stock-flow consistent macroeconomic model for asset price bubbles

M. R. Grasselli

Mathematics and Statistics, McMaster University and The Fields Institute
Joint with B. Costa Lima (Morgan Stanley) and A. Nguyen Huu (CERMICS)

14th Winter School on Mathematical Finance, Lunteren,
January 28, 2015

Rational bubbles

- Consider a representative agent solving

$$\sup_c E_t \left[\sum_{j=1}^{\infty} \beta^{j-t} u(c_j) \right]$$

for exogenously given (e_t, d_t).

- The general solution for this problem is of the form $p_t = F_t + B_t$ where

$$F_t = \sum_{j=1}^{\infty} \beta^j E_t \left[d_{t+j} u'(e_{t+j} + d_{t+j}) \right]$$

is the fundamental price and B_t is a bubble term satisfying

$$E_t[B_{t+1}] = \beta^{-1} B_t \tag{1}$$

Consequences

- $B_t \geq 0$ for all t.
- Any nonzero rational bubble must start with $B_0 > 0$.
- If $T < \infty$, $B_t = 0$ for all $0 \leq t \leq T$, and this result is robust with respect to diverse information (Tirole 1982).
- If $T = \infty$, bubbles can exit in a myopic rational expectations equilibrium.
- Rational bubbles cannot exist in a fully dynamic REE with finitely many infinitely lived agents.
- They can exit in an overlapping generations models provided $0 < \bar{r} < g$, where $\bar{r}$ is the asymptotic real interest rate and g is the rate of growth of the economy (Tirole 1985).

Alternative models (Shiller, 1984)

- Consider a model where sophisticated investors have a demand function (portion of shares) of the form

$$Q_t^i = \frac{E_t[R_{t+1}] - \alpha}{\phi}. \tag{2}$$

- In addition, suppose there are noise traders who react to fads Y_t through a demand function $Q_t^n = Y_t/p_t$.
- In equilibrium we have $Q_t + \frac{Y_t}{p_t} = 1$.
- Inserting this into (2) and solving recursively leads to

$$p_t = \sum_{j=1}^{\infty} \frac{E_t[d_{t+j}] + \phi E_t[Y_{t-1+j}]}{(1+\alpha+\phi)^j}. \tag{3}$$

- This is also consistent with prices being not very forecastable.

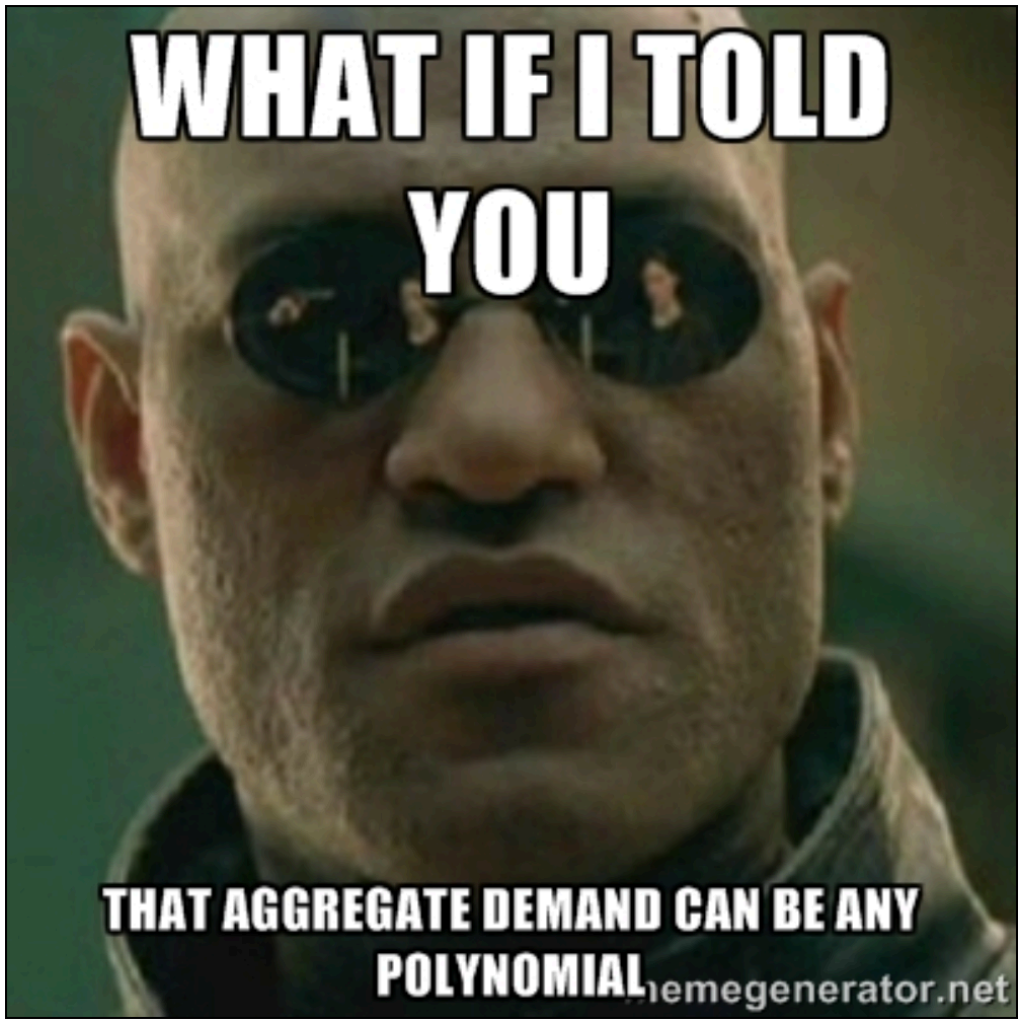
Other sources of inefficiencies

- Noise trader risk (DeLong, Shleifer, Summers and Waldmann 1990): prices deviate from fundamentals due to uncertainty created by noise traders, who can earn higher expected returns than sophisticated investors.
- Limits of arbitrage (Shleifer and Vishny 1997): fund managers leaving the market exactly when they are needed to restore fundamental value.
- No short-sales and diverse beliefs (Miller 1977, Harrison and Kreps 1978): pessimists stay on sidelines and optimists overbid
- Overconfidence (Scheinkman and Xiong 2003): mean reverting confidence levels lead to prices that contain an option to re-sell the asset at a later time.
- These are all microeconomic models. What about macro?

Dynamic Stochastic General Equilibrium (DSGE)

- Seeks to explain the aggregate economy using theories based on strong microeconomic foundations.
- Collective decisions of rational individuals over a range of variables for both present and future.
- All variables are assumed to be simultaneously in equilibrium.
- Equilibrium is only disrupted by exogenous shocks.
- The only way the economy can be in disequilibrium at any point in time is through decisions based on wrong information.
- Money is neutral in its effect on real variables.

SMD theorem: something is rotten in GE land



Minsky's alternative interpretation of Keynes

- Neoclassical economics is based on barter paradigm: money is convenient to eliminate the double coincidence of wants.
- In a modern economy, firms make complex portfolios decisions: which assets to hold and how to fund them.
- Financial institutions determine the way funds are available for ownership of capital and production.
- Uncertainty in valuation of cash flows (assets) and credit risk (liabilities) drive fluctuations in real demand and investment.
- Economy is fundamentally cyclical, with each state (boom, crisis, deflation, stagnation, expansion and recovery) containing the elements leading to the next in an identifiable manner.

Minsky's Financial Instability Hypothesis

- Start when the economy is doing well but firms and banks are conservative.
- Most projects succeed - "Existing debt is easily validated: it pays to lever".
- Revised valuation of cash flows, exponential growth in credit, investment and asset prices.
- Beginning of "euphoric economy": increased debt to equity ratios, development of Ponzi financier.
- Viability of business activity is eventually compromised.
- Ponzi financiers have to sell assets, liquidity dries out, asset market is flooded.
- Euphoria becomes a panic.
- "Stability - or tranquility - in a world with a cyclical past and capitalist financial institutions is destabilizing".

Stock-Flow Consistent models

- Stock-flow consistent models emerged in the last decade as a common language for many heterodox schools of thought in economics.
- They consider both real and monetary factors simultaneously.
- Specify the balance sheet and transactions between sectors.
- Accommodate a number of behavioural assumptions in a way that is consistent with the underlying accounting structure.
- Reject the RARE individual (representative agent with rational expectations) in favour of SAFE (sectoral average with flexible expectations) modelling.
- See Godley and Lavoie (2007) for the full framework.

Goodwin Model - SFC matrix

Balance Sheet	Households	Firms		Sum
		current	capital	
Capital			$+pK$	pK
Sum (net worth)	0	0	V_f	pK
Transactions				
Consumption	$-pC$	$+pC$		0
Investment		$+pI$	$-pI$	0
Acct memo [GDP]		$[pY]$		
Wages	$+W$	$-W$		0
Profits		$-\Pi$	$+\Pi_u$	0
Sum	0	0	0	0
Flow of Funds				
Capital			$+pI$	pI
Sum	0	0	Π_u	pI
Change in Net Worth	0	$pI + \dot{p}K - p\delta K$		$\dot{p}K + p\dot{K}$

Table: SFC table for the Goodwin model.

Goodwin Model - Differential equations

- Define

$$\omega = \frac{\mathrm{w}\ell}{pY} = \frac{\mathrm{w}}{pa} \quad \text{(wage share)}$$

$$\lambda = \frac{\ell}{N} = \frac{Y}{aN} \quad \text{(employment rate)}$$

- It then follows that

$$\frac{\dot{\omega}}{\omega} = \frac{\dot{\mathrm{w}}}{\mathrm{w}} - \frac{\dot{p}}{p} - \frac{\dot{a}}{a} = \Phi(\lambda, i, i^e) - i - \alpha$$

$$\frac{\dot{\lambda}}{\lambda} = \frac{1-\omega}{\nu} - \alpha - \beta - \delta$$

- In the original model, all quantities were real (i.e divided by p), which is equivalent to setting $i = i^e = 0$.

Where does Φ come from?

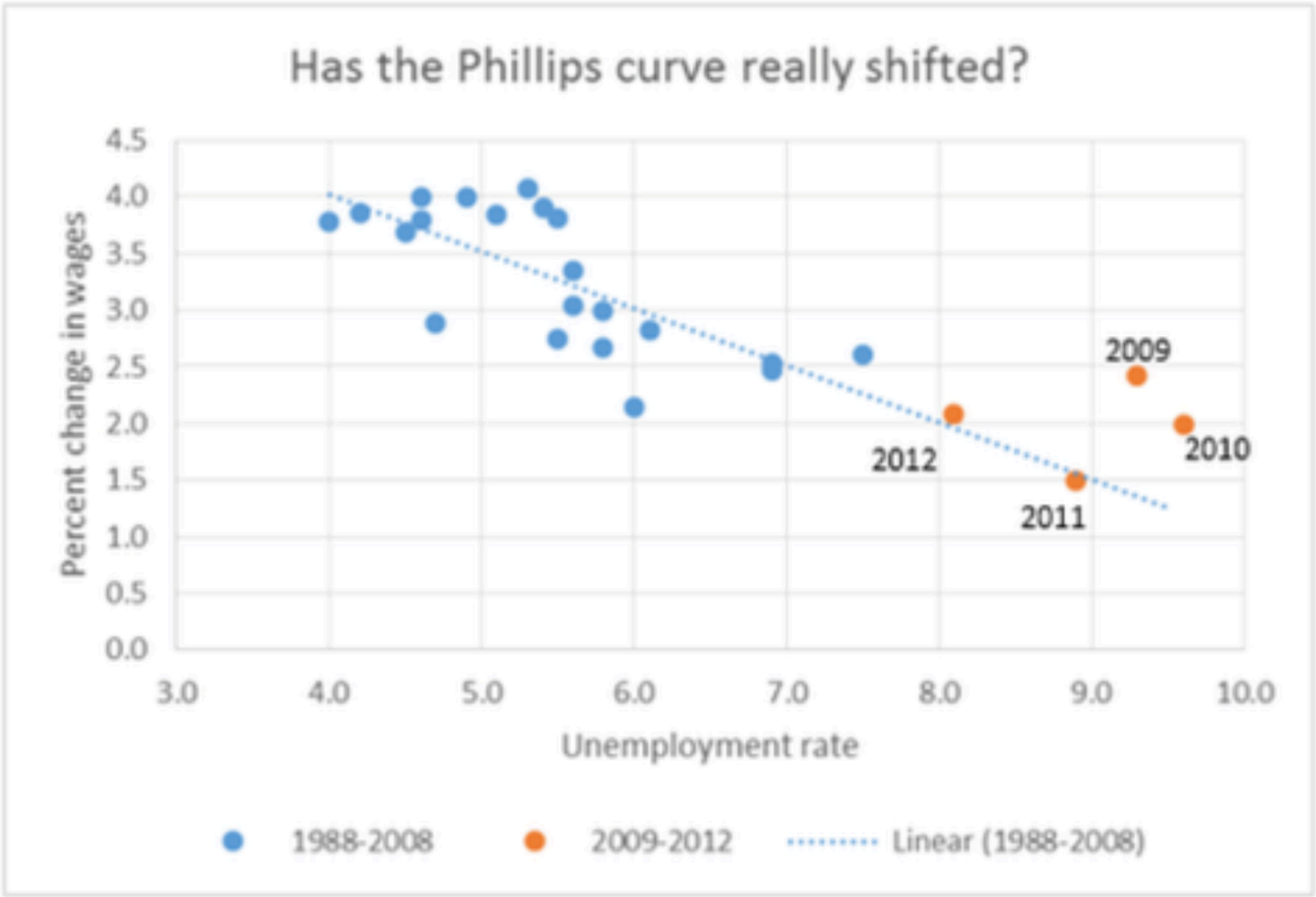
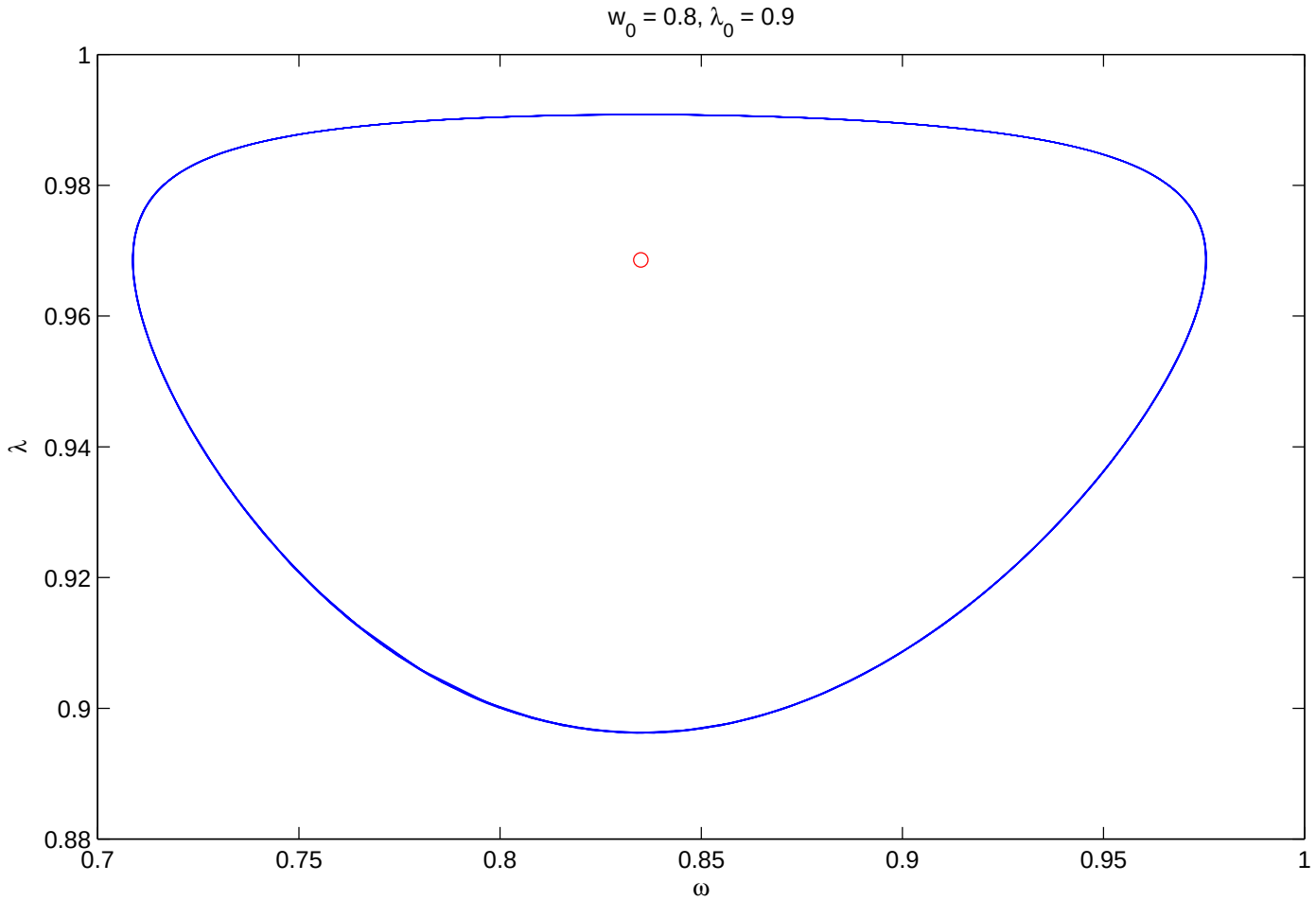


Figure: Krugman - July 15, 2014

Example 1: Goodwin model



Testing Goodwin on OECD countries

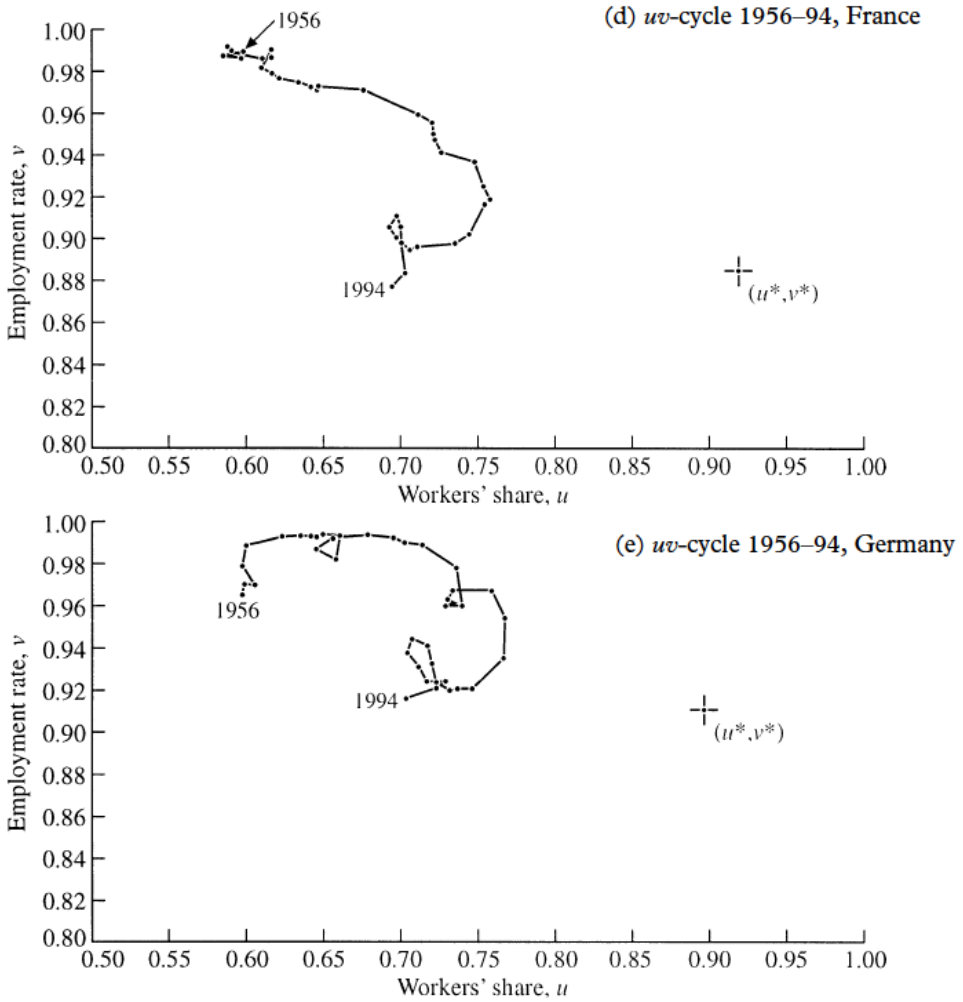


Figure: Harvie (2000)

Correcting Harvie (1970 to 2009)

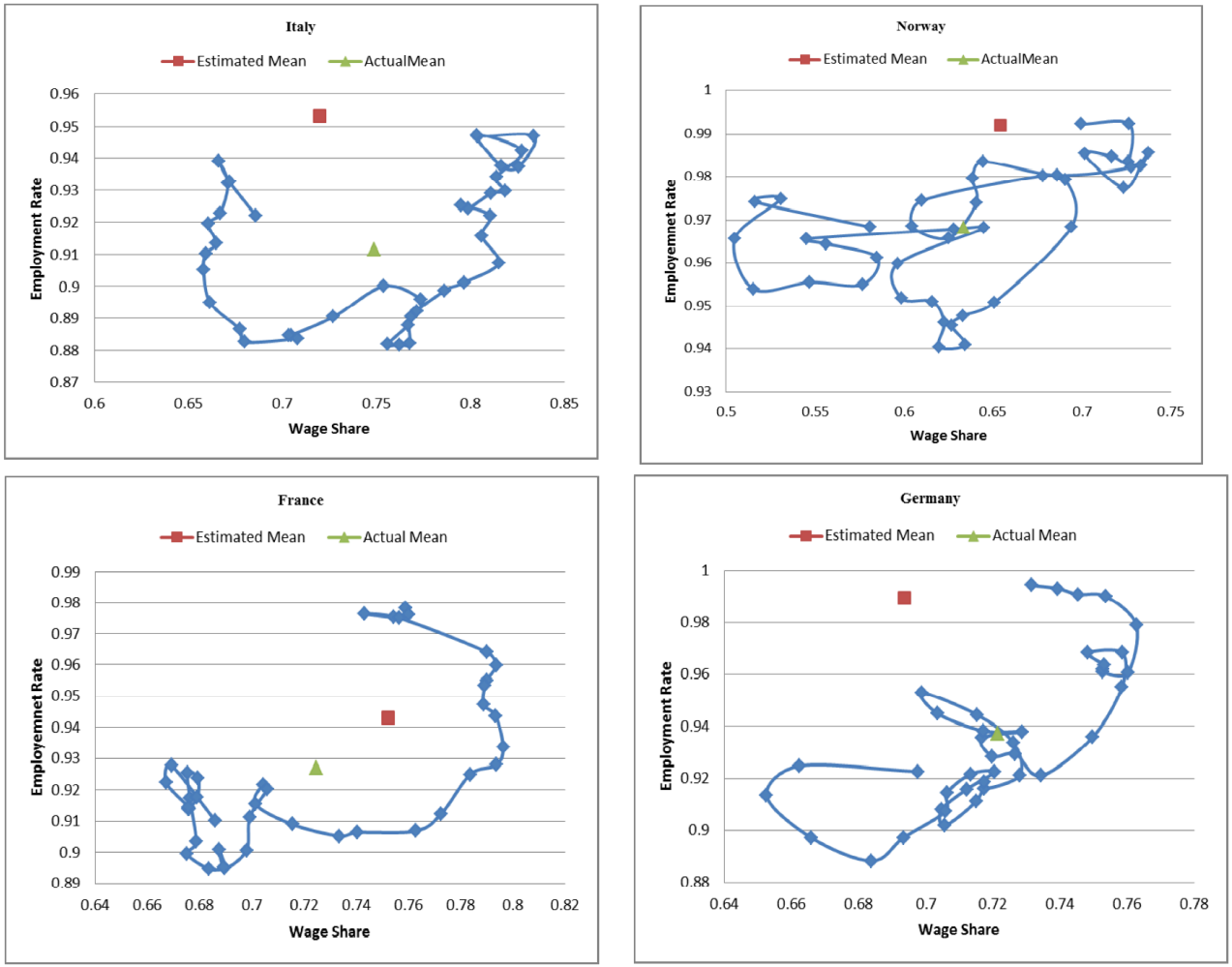


Figure: Grasselli and Maheshwari (2015, in progress)

What about shocks?

- Nguyen Huu and Costa Lima (2014) introduce stochastic productivity of the form

$$da_t := a_t d\alpha_t = a_t[\alpha dt - \sigma(\lambda_t) dW_t]$$

leading to a modified model of the form

$$\frac{\dot{\omega}}{\omega} = \Phi(\lambda) - \alpha + \sigma^2(\lambda_t)dt + \sigma(\lambda_t)dW_t$$
$$\frac{\dot{\lambda}}{\lambda} = \frac{1-\omega}{\nu} - \alpha - \beta - \delta + \sigma^2(\lambda_t)dt + \sigma(\lambda_t)dW_t$$

- They then prove the existence of stochastic orbits generalizing the original Goodwin cycles.

Example 2: stochastic orbits of a Goodwin model with productivity shocks

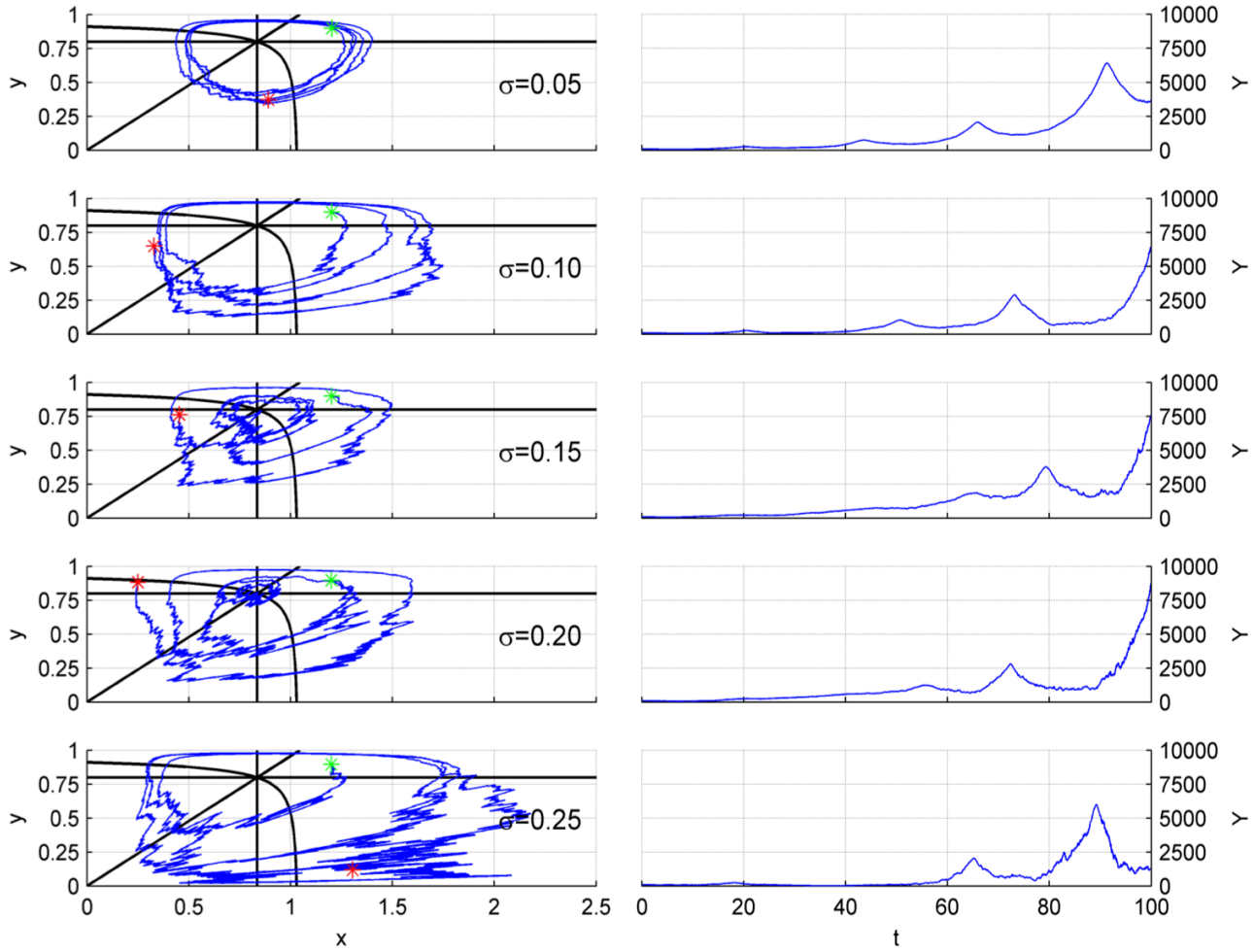


Figure: Figure 3 in Nguyen Huu and Costa Lima (2014)

SFC table for Keen (1995) model

Balance Sheet	Households	Firms		Banks	Sum
		current	capital		
Deposits	$+D$			$-D$	0
Loans			$-L$	$+L$	0
Capital			$+pK$		pK
Sum (net worth)	V_h	0	V_f	0	pK
Transactions					
Consumption	$-pC$	$+pC$			0
Investment		$+pI$	$-pI$		0
Acct memo [GDP]		$[pY]$			
Wages	$+W$	$-W$			0
Interest on deposits	$+rD$			$-rD$	0
Interest on loans		$-rL$		$+rL$	0
Profits		$-\Pi$	$+\Pi_u$		0
Sum	S_h	0	$S_f - pI$	0	0
Flow of Funds					
Deposits	$+\dot{D}$			$-\dot{D}$	0
Loans			$-\dot{L}$	$+\dot{L}$	0
Capital			$+pI$		pI
Sum	S_h	0	Π_u	0	pI
Change in Net Worth	S_h	$(S_f + \dot{p}K - p\delta K)$			$\dot{p}K + p\dot{K}$

Table: SFC table for the Keen model.

Keen model - Investment function

- Assume now that new investment is given by

$$\dot{K} = \kappa(\pi) Y - \delta K$$

where $\kappa(\cdot)$ is a nonlinear increasing function of profits $\pi = 1 - \omega - rd$.

- This leads to external financing through debt evolving according to

$$\dot{D} = \kappa(\pi) Y - \pi Y$$

- The economy grows at a rate

$$g(\pi) := \frac{\dot{Y}}{Y} = \frac{\kappa(\pi)}{\nu} - \delta.$$

Keen model - Differential Equations

Denote the debt ratio in the economy by $d = D/Y$, the model can now be described by the following system

$$\begin{aligned} \dot{\omega} &= \omega\left[\Phi(\lambda) - \alpha\right] \\ \dot{\lambda} &= \lambda\left[g(\pi) - \alpha - \beta\right] \\ \dot{d} &= \kappa(\pi) - \pi - dg(\pi) \end{aligned} \tag{4}$$

Example 3: convergence to the good equilibrium in a Keen model

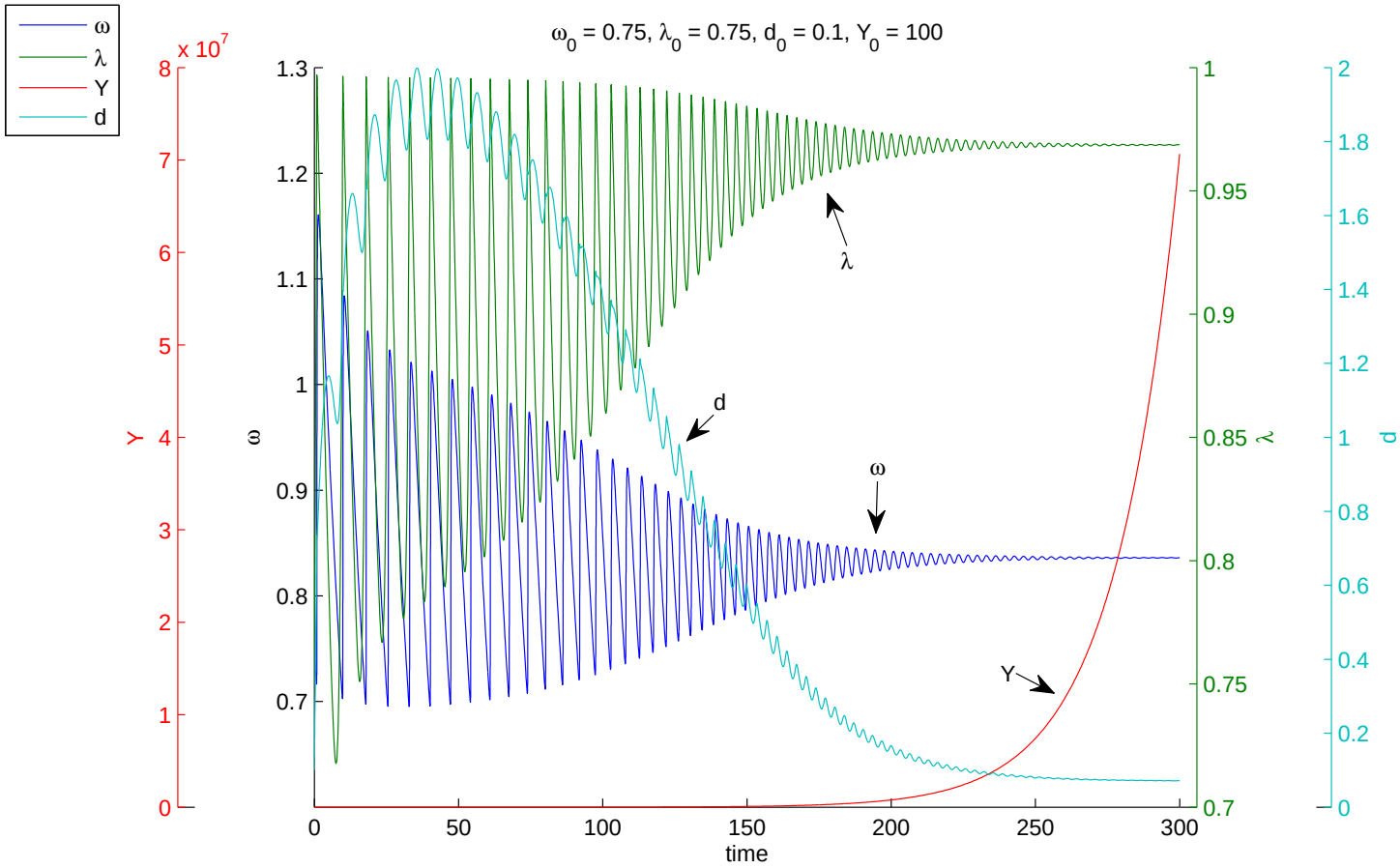


Figure: Grasselli and Costa Lima (2012)

Example 4: explosive debt in a Keen model

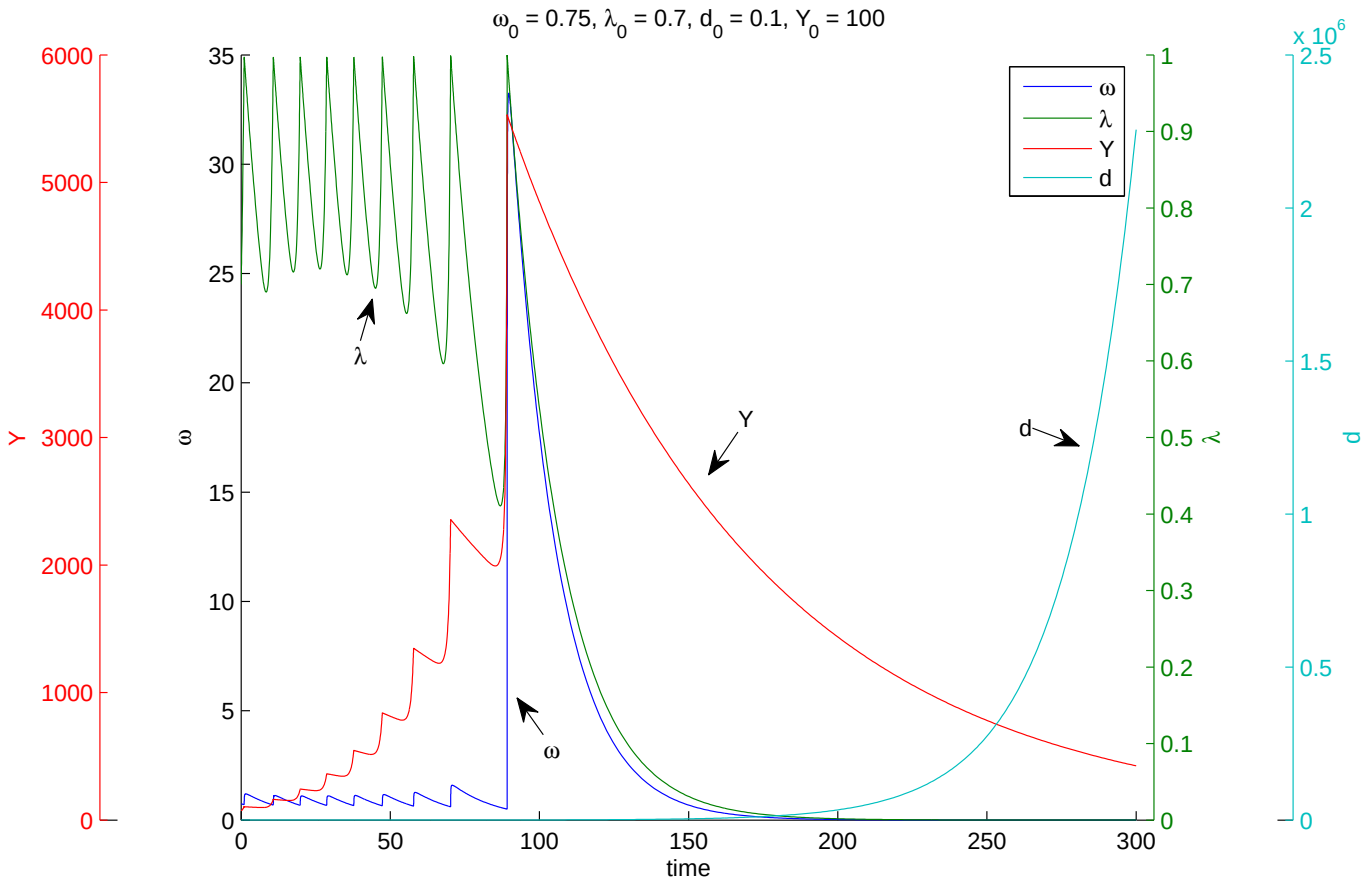
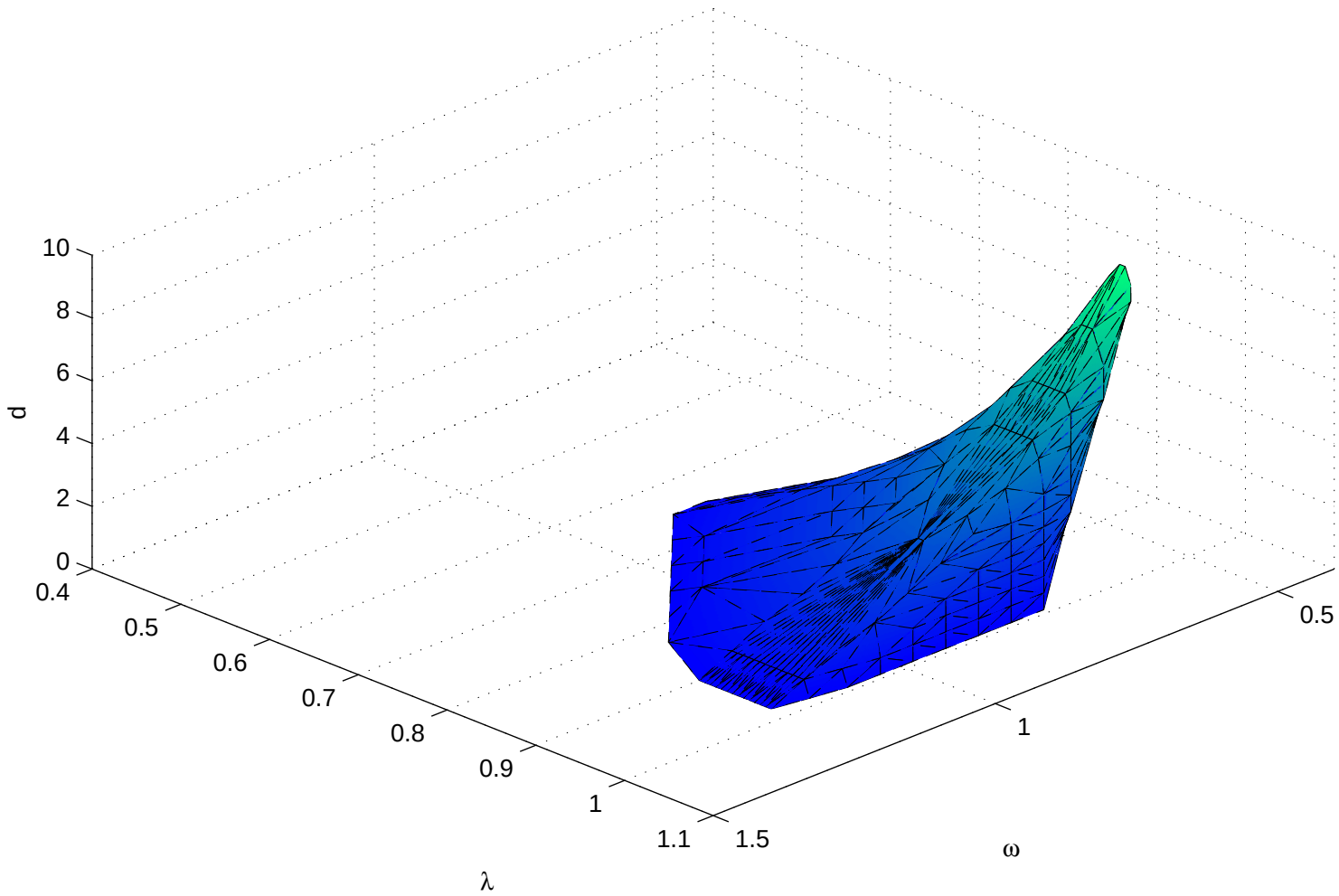
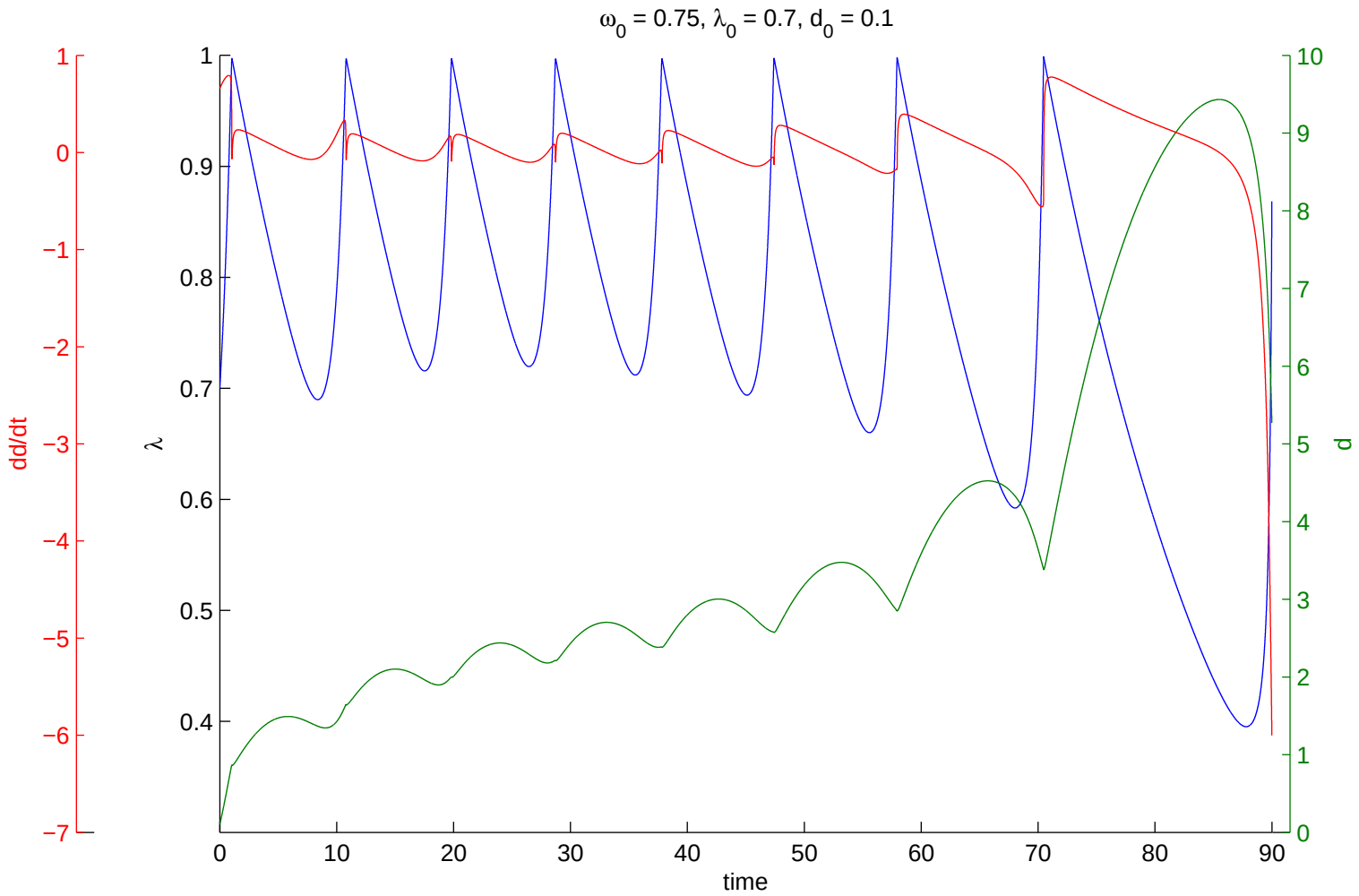


Figure: Grasselli and Costa Lima (2012)

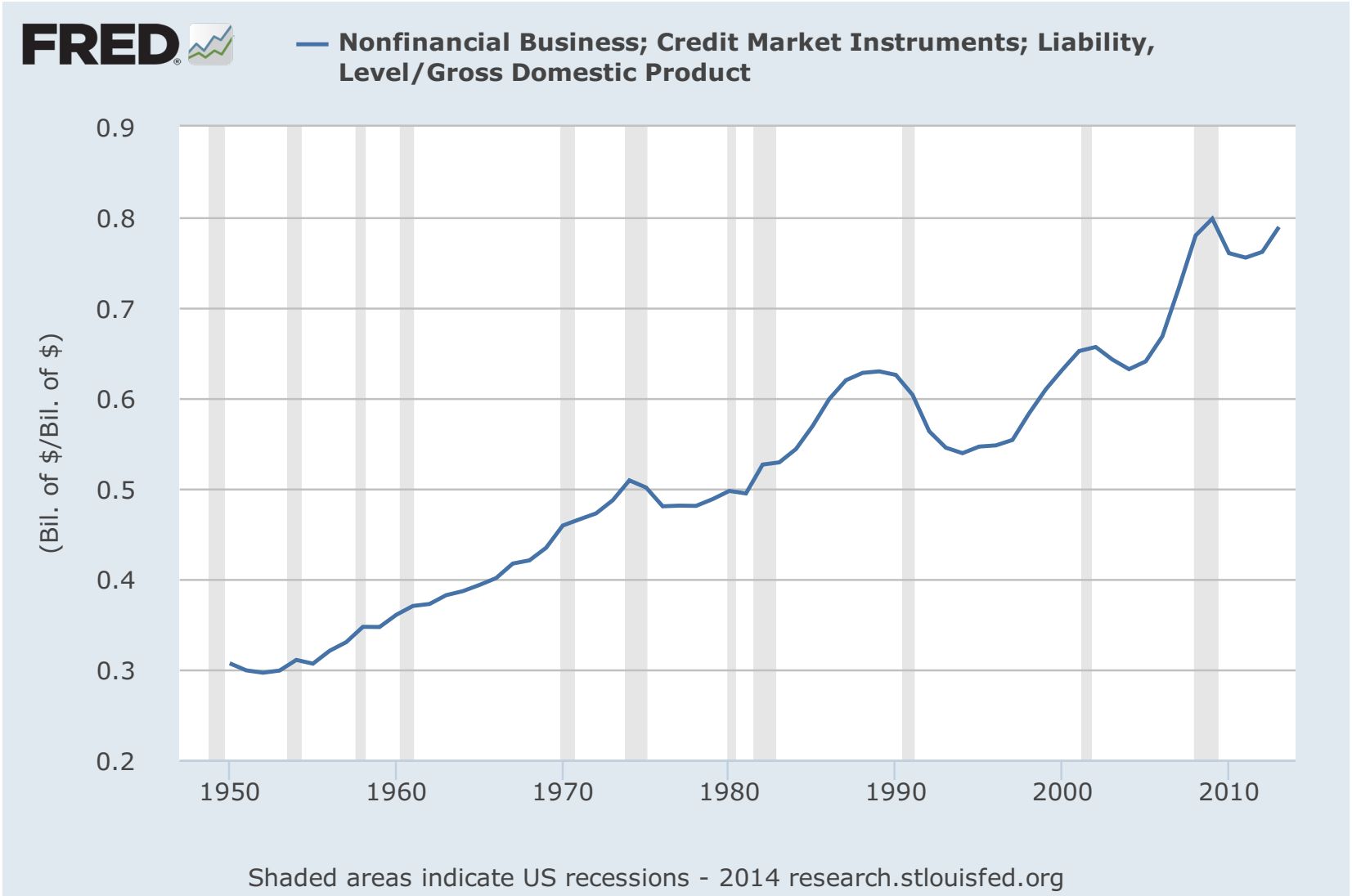
Basin of convergence for Keen model



Example 3 (continued): explosive debt in a Keen model



Corporate Debt share in the US 1950-2014



Private debt matters!

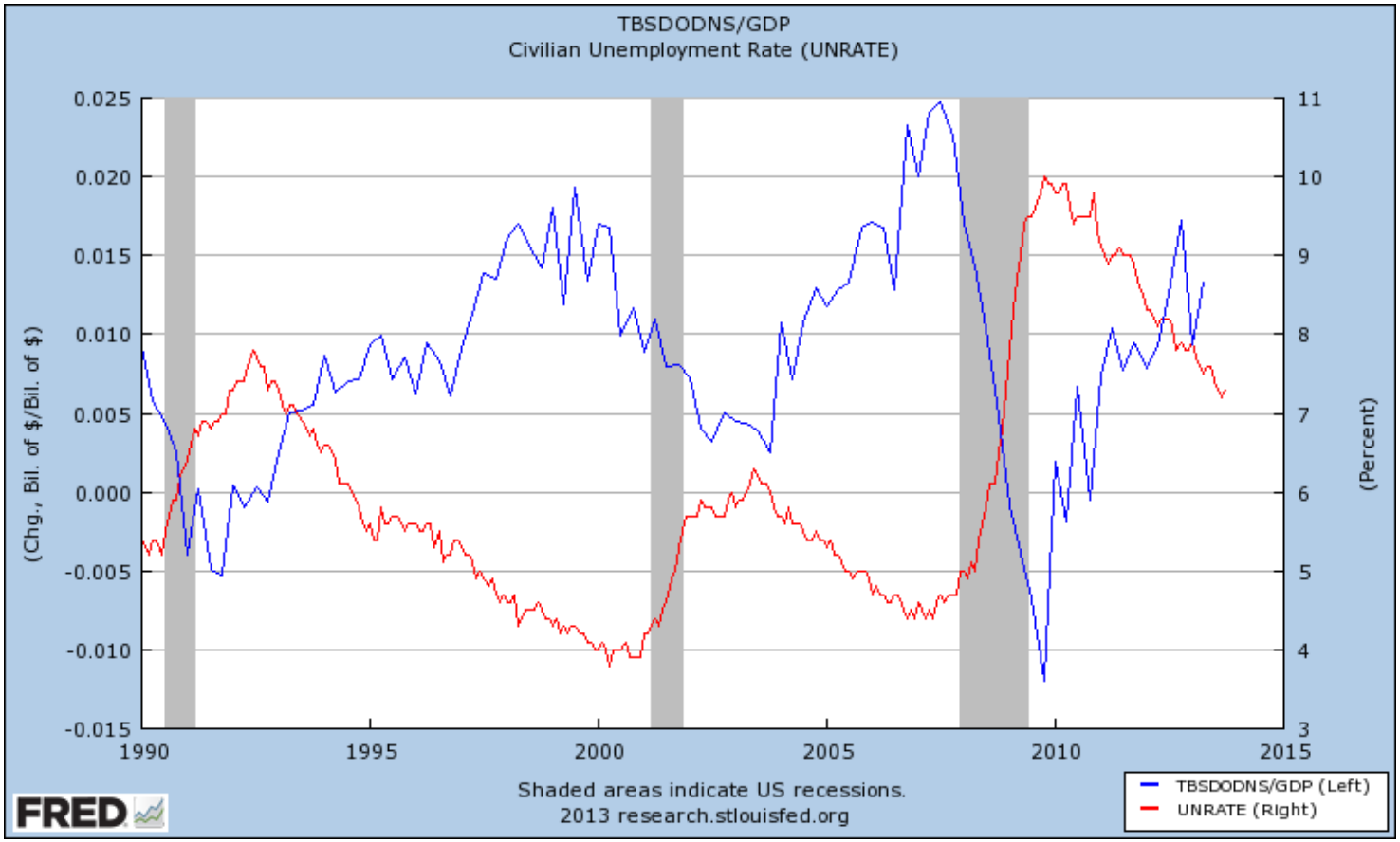


Figure: Change in debt and unemployment.

Ponzi financing

To introduce the destabilizing effect of purely speculative investment, we consider a modified version of the previous model with

$$\dot{D} = \kappa(\pi)Y - \pi Y + F$$
$$\dot{F} = \Psi(g(\pi))F$$

where $\Psi(\cdot)$ is an increasing function of the growth rate of economic output

$$g(\omega, d) = \frac{\kappa(\pi)}{\nu} - \delta.$$

Ponzi financing - Differential equations

With Ponzi financing the dynamical system becomes

$$\begin{aligned}
\dot{\omega} &= \omega\left[\Phi(\lambda) - \alpha\right] \\
\dot{\lambda} &= \lambda\left[g(\pi) - \alpha - \beta\right] \\
\dot{d} &= \kappa(\pi) - \pi - dg(\pi) + f \\
\dot{f} &= f\left[\Psi\left(g(\pi)\right) - g(\pi)\right]
\end{aligned} \tag{5}$$

Ponzi financing - Equilibria and stability

- We find that $(\overline{\omega}_1, \overline{\lambda}_1, \overline{d}_1, 0)$ is a stable equilibrium iff

$$\Psi(\alpha + \beta) < \alpha + \beta.$$

- Introducing $u = 1/d$ we find that

$$(\overline{\omega}_2, \overline{\lambda}_2, \overline{d}_2, \overline{p}) = (0, 0, +\infty, 0)$$

is stable iff

$$\Psi(g_0) < g_0.$$

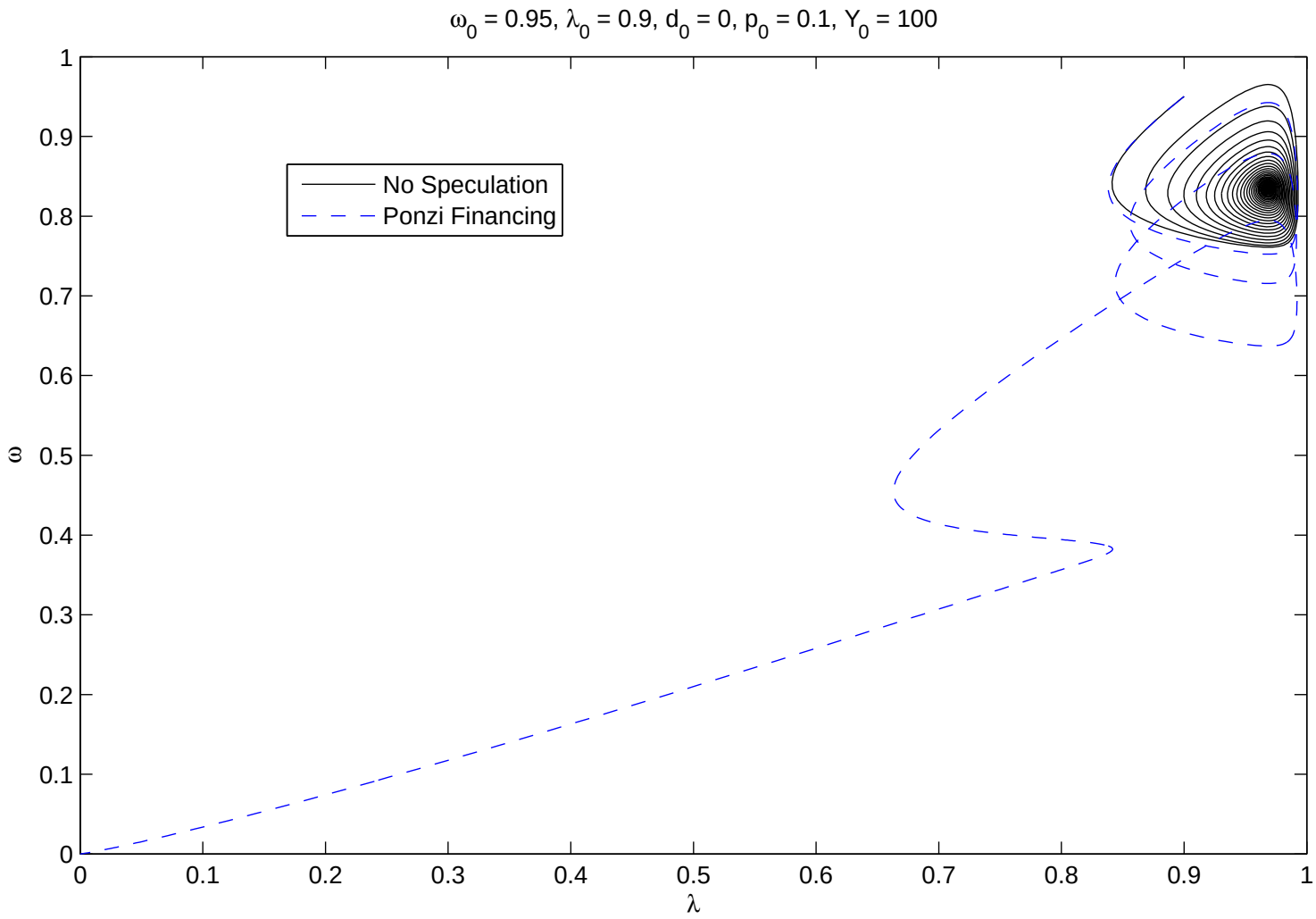
- Moreover, introducing , $x = 1/p$ and $v = p/d$ we find that

$$(\overline{\omega}_3, \overline{\lambda}_3, \overline{d}_3, \overline{p}) = (0, 0, +\infty, +\infty)$$

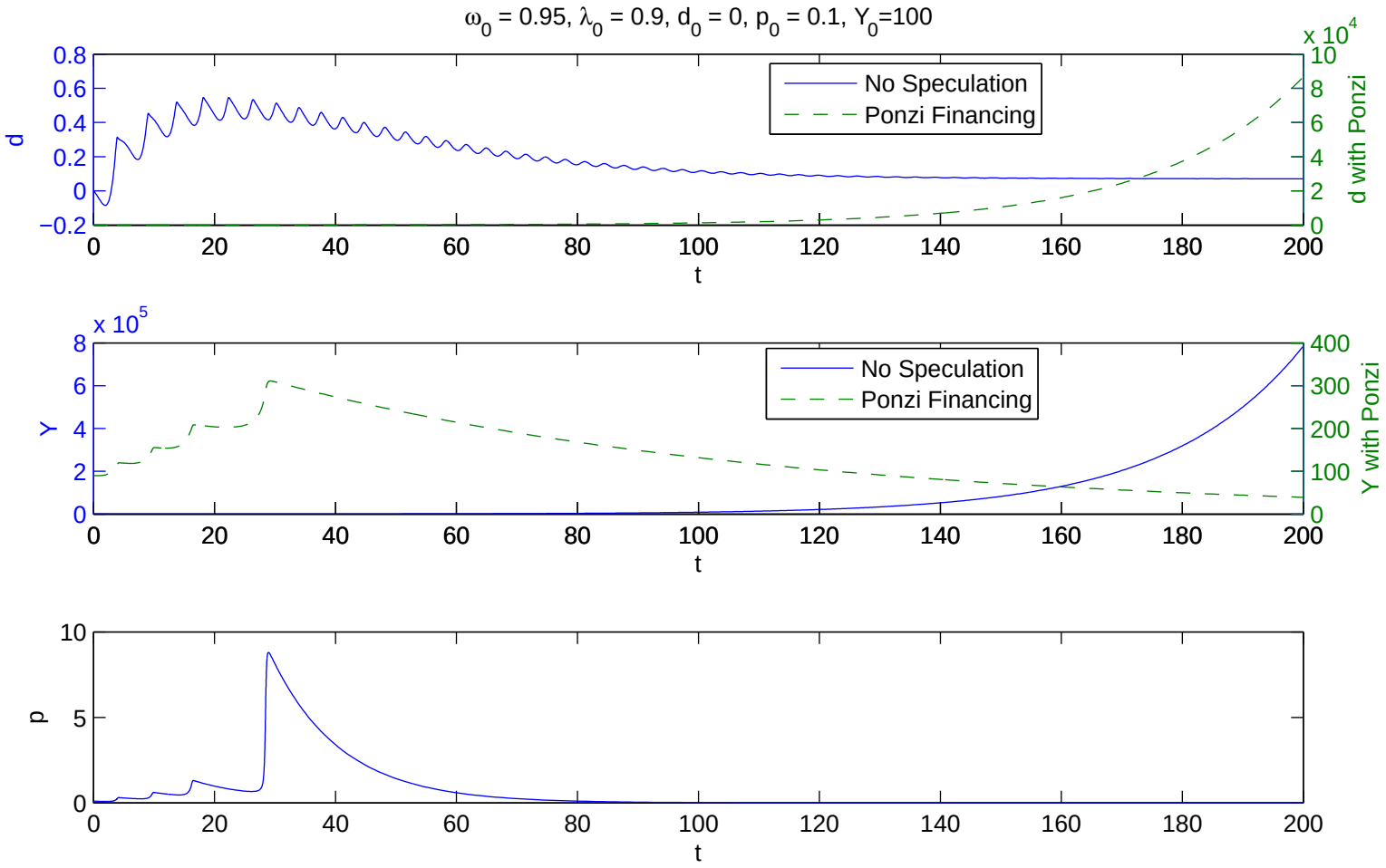
is stable iff

$$g_0 < \Psi(g_0) < r.$$

Example 4: effect of Ponzi financing



Example 4 (continued): effect of Ponzi financing



Credit and bubbles

- In *Manias, Panics, and Crashes*, Kindelberger and Aliber (2011) state that "most increases in the supply of credit do not lead to a mania - but nearly every mania has been associated with rapid growth in the supply of credit to a particular group of borrowers."
- Recall the Quantity Theory of Money equation

$$MV = pY, \tag{6}$$

where M is the money supply and V the velocity of circulation.

- In Werner (1997), this is replaced by

$$M_R V_R = pY \tag{7}$$

$$M_F V_F = SQ_F, \tag{8}$$

where R and F denote real and financial transactions respectively.

The monetary roots of bubbles and crashes

- In Corsi and Sornette (2012), this is model through

$$dM_t^F = \mu_F S_t M_t^F dt + \sigma_M M_t^F dW_t^F \tag{9}$$

$$dS_t = \mu_S M_t^F S_t dt + \sigma_S S_t dW_t^S, \tag{10}$$

  which exhibits super-exponential behaviour.

- In our notation, the deterministic version of this model is

$$F = \frac{dM_F}{dt} = \mu_F S M_F \tag{11}$$

$$\frac{dS}{dt} = \mu_S M_F S \tag{12}$$

  and exhibits finite-time singularity (FTS).

Stock price dynamics

- Instead of (9), we consider a stock price process of the form

$$\frac{dS_t}{S_{t-}} = r_b dt + \sigma dW_t + j\mu_t dt - dJ_t$$

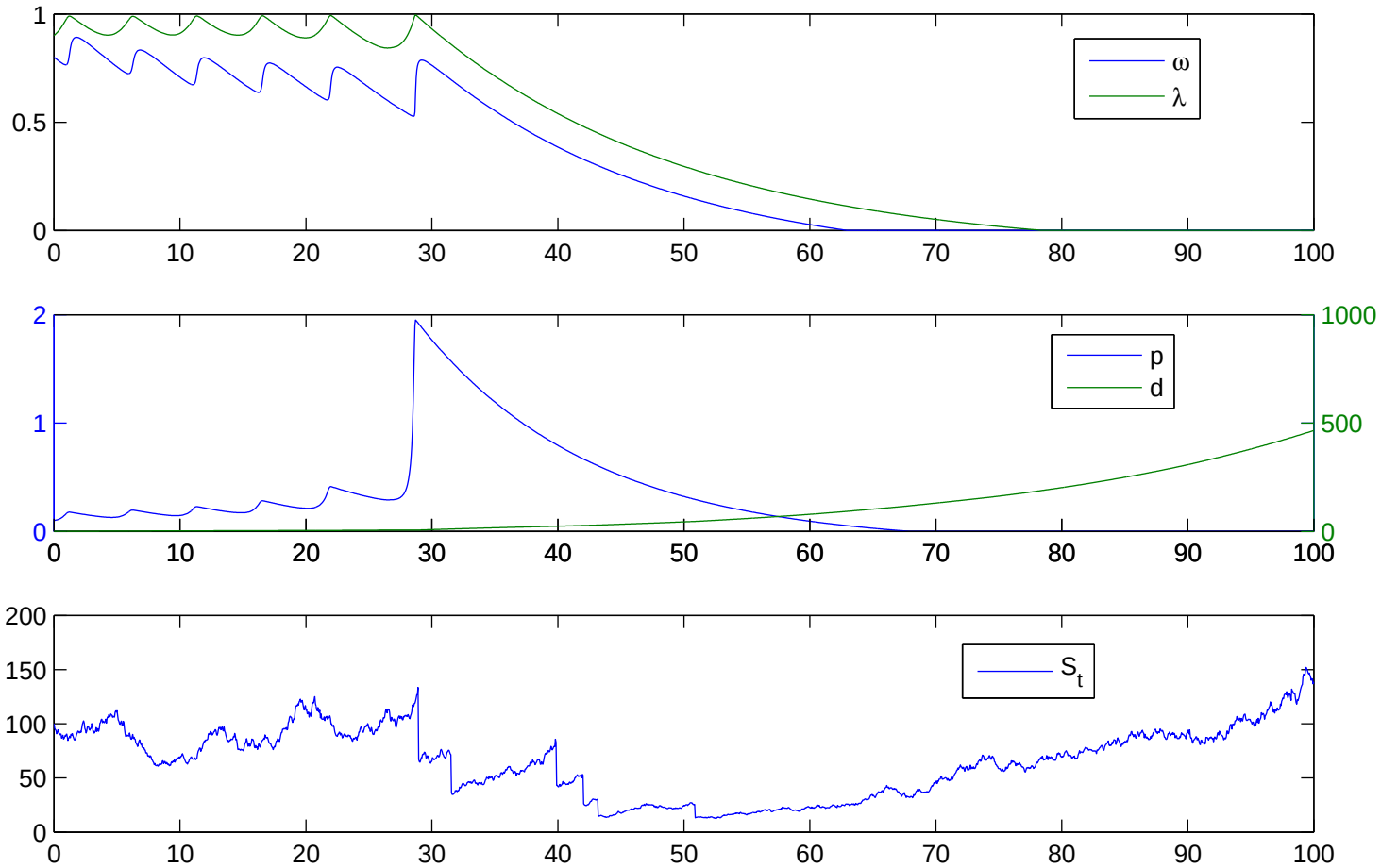
where J_t is an inhomogenous Poisson process with intensity $\mu_t = M(f(t))$ and jump sizes distributed on $(0,1)$ with mean j.

- The interest rate for private debt is modelled as $r_t = r_b + r_p(t)$ where

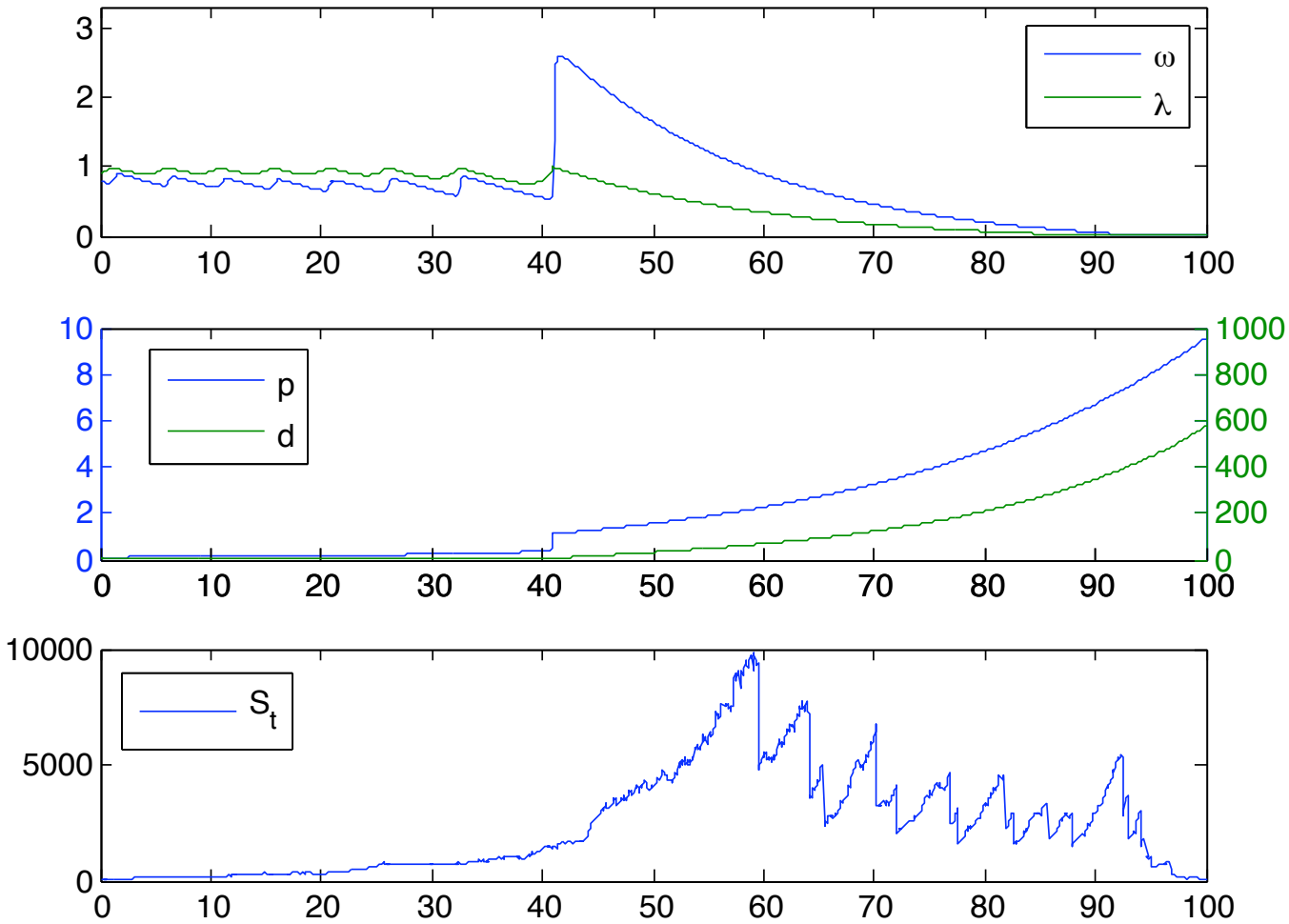
$$r_p(t) = \frac{\rho_1}{(S_t + \rho_2)^{\rho_3}}$$

for positive constants ρ_1, ρ_2, ρ_3.

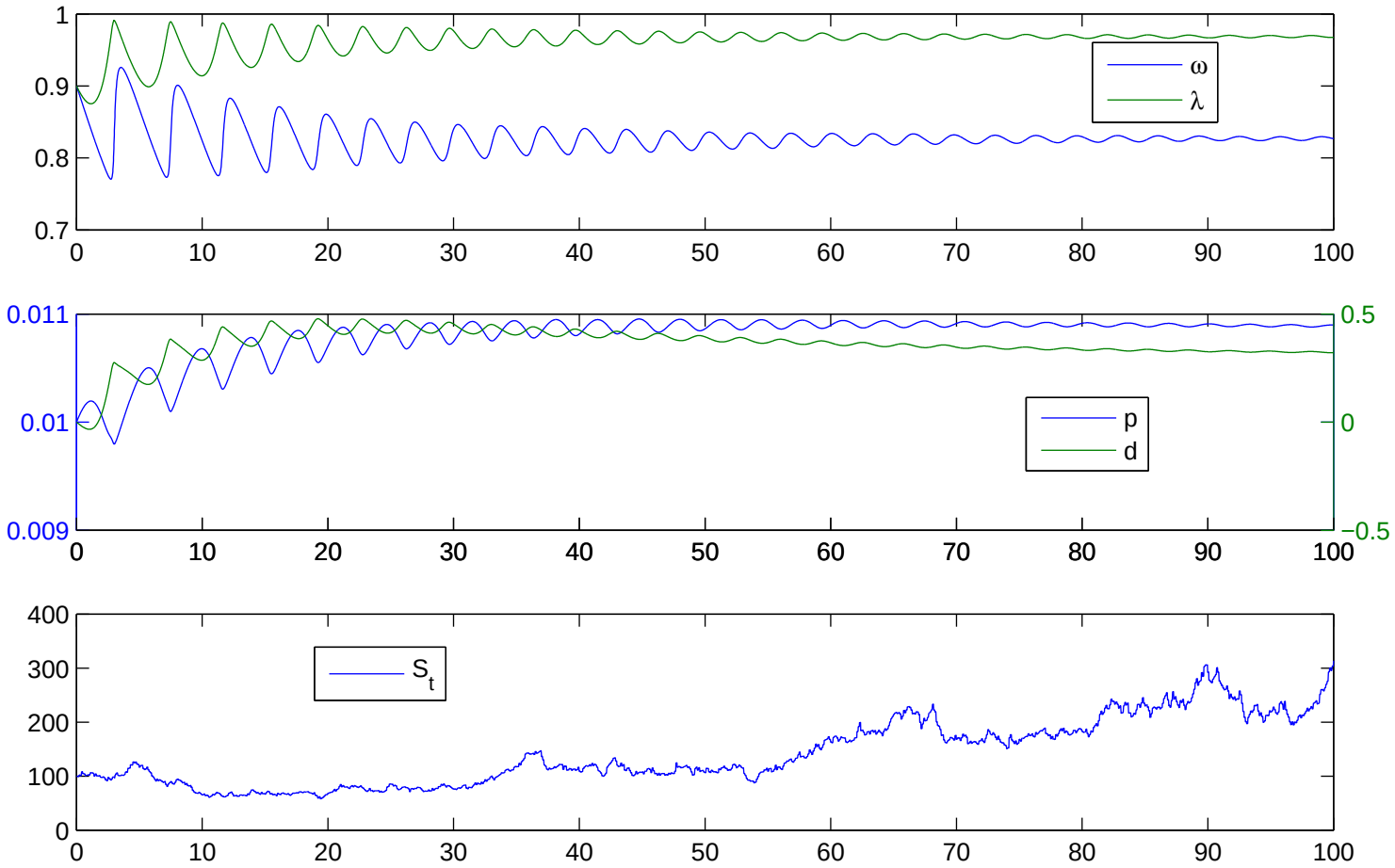
Example 5: stock prices, explosive debt, zero speculation



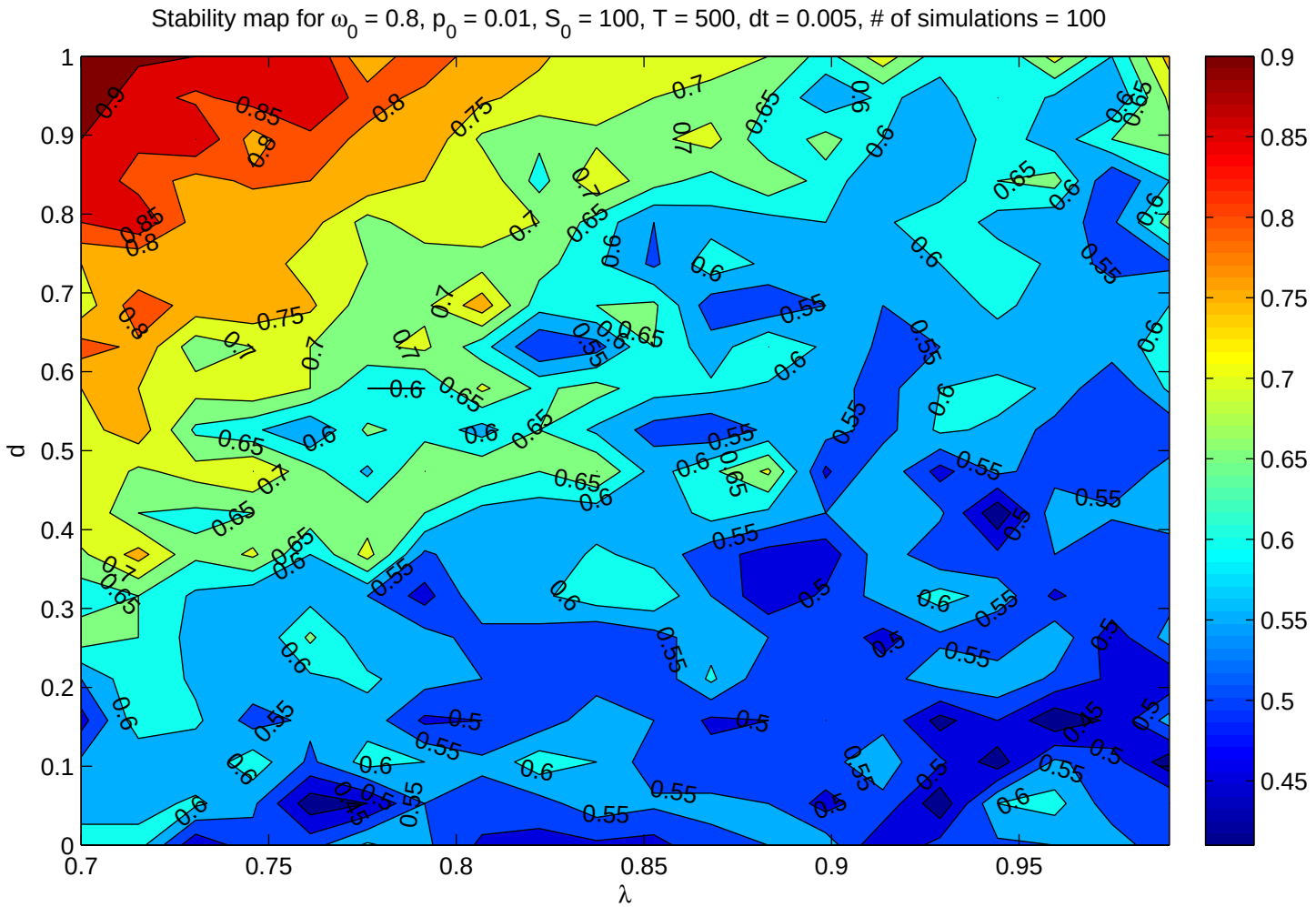
Example 6: stock prices, explosive debt, explosive speculation



Example 7: stock prices, finite debt, finite speculation



Stability map



Extensions

- In Costa Lima, Grasselli, and Nguyen Huu (2014), we consider a wage-price dynamics of the form

$$\frac{\dot{\mathrm{w}}}{\mathrm{w}} = \Phi(\lambda) + \gamma i \,, \tag{13}$$

$$i = \frac{\dot{p}}{p} = -\eta_p \left[1 - \xi \frac{\mathrm{w}}{ap}\right] = \eta_p(\xi\omega - 1) \tag{14}$$

  for a constants $0 \leq \gamma \leq 1$, $\eta_p > 0$ and $\xi \geq 1$, as well as a financial flow of the form $\dot{F} = \Psi(g(\pi))Y$.
- In Grasselli and Nguyen Huu (2015) we treat consumption and investment separately and inventory dynamics.
- In Choi and Grasselli (2015) we investigate the role of credit in the Great Moderation.
- Other possible extensions include exchange rates and import/export dynamics, as well as mesoeconomic foundations.

Concluding remarks

- We provided a stock-flow consistent model for real-financial interactions as an extension of the Goodwin-Keen labour, investment, and debt dynamics.
- The modelling framework is an alternative to the dominant microfounded DSGE paradigm in macroeconomics.
- It incorporates insights from endogenous money theory, sectoral balances, and Minskian financial instability.
- Opens up new avenues for the application of modern dynamical systems techniques to economics.
- Work has just begun ...
- Dankjewel!