INTERNATIONAL DEBT DELEVERAGING

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Abstract
This paper provides a framework to understand the adjustment triggered by an episode of debt deleveraging among financially integrated countries. During a period of international deleveraging, world consumption demand is depressed and the world interest rate is low, reflecting a high propensity to save. If exchange rates are allowed to float, deleveraging countries can rely on depreciations to increase production and mitigate the fall in consumption associated with debt reduction. The key insight of the paper is that in a monetary union this channel of adjustment is shut off, because deleveraging countries cannot depreciate against the other countries in the monetary union, and therefore the fall in the demand for consumption and the downward pressure on the interest rate are amplified. As a result, deleveraging in a monetary union can generate a liquidity trap and an aggregate recession. For instance, the model predicts that international deleveraging by peripheral euro area countries can account for around 24% of the output loss experienced by the euro area in the two years following the 2008 financial crisis. (JEL: E52, F41, F45, G15.)

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