Discussion - Banks, Capital Flows and Financial Crises - by Ozge Akinci and Albert Queralto

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OVERVIEW

- Key features - DSGE with occasionally binding constraints. Banks intermediating funds from savers to investors. Banks issue equity preparing balance sheet for next period.
- Key Results -
  - Model nests business cycle fluctuations and crises events.
  - Lower R increases probability of financial crises due to the decrease in bank equity
  - Main trigger of financial crises is shock to asset holdings (capital quality)

Relation with previous literature

- Mendoza(2012) - Household borrows and invests. $\downarrow$ precautionary savings $\Rightarrow$ possibility of binding constraints $\Rightarrow$ when it binds level of debt is restricted $\Rightarrow$ low investment

  Main shocks - TFP and R^*

- Framework here introduces banks but

  $\downarrow$ bank equity $\Rightarrow$ possibility of binding constraints $\Rightarrow$ when it binds level of debt is restricted $\Rightarrow$ low investment

  Main shocks - Capital Quality and R^*

  But bank equity works very much like a (costly) saving decision as it is for the households in Mendoza(2012).

- How much different is the mechanism here?

BANKS - FUNDING STRUCTURE

- Home vs Foreign Funds
    - Previous version had it (banks could more easily steal resources from foreigners). Different treatment of home and foreigners is done elsewhere (e.g. Broner and co-authors). Careful with arbitrage issues.
    - As now borrowing from home and abroad are equal what is the small open economy dimension bringing to the model?
    - Presumably same mechanism in a close economy model After a capital quality shock, depositors would restrict funding leading to decrease in bank assets as is currently happening. (Shock to R^* is equivalent to shock on borrowing rate of banks in a close economy (How low rates maintained by CB affect this process?))
- deposits vs wholesale funding?
- Debt vs equity funding (in the model but incorporate different trade-offs, e.g. (Adrian and Shin (2012))

Banks - Risk

- Bank's value function is linear on networth. Precautionary saving exists since on states where constraint binds equity is needed, but all states are equally weighted.
- Leaves aside potential interesting interactions from issues of excessive risk taking or problems in risk assessment due to information asymmetry/incentives.

CRISES SIMULATION

- Shocks - $\downarrow$ Capital quality $\uparrow R^*$ (up until the crises).
- Crisis occur but no prior overborrowing, also no reversal of NX?
- Driver here is really the quality of capital/obsolescence.
- Banking Crises - Is that a capital quality shock or a funding squeeze that occurs and in turn implies less investment, which then trigger $\downarrow$ asset prices and further decreases in bank asset holding/investment? That would perhaps require to model the funding decision regarding potential risk on bank assets.

POLICY

- This version - key is bank equity but one perhaps needs to discuss more in depth why equity is too low from a social optimal, since it is too costly to increase equity to avoid crises all together.
- Previous version had trade-off between home and foreign bank borrowing. Caveat - ex-post it is clear that bigger recession are preceded by higher credit growth, but ex-ante it is still not clear which episodes will be good credit growth and which will be bad, increasing problem for ex-ante policy intervention.