

# Discussion of “Bank Capital in the Short and in the Long Run” by Mendicino, Nikilov, Suarez and Supera

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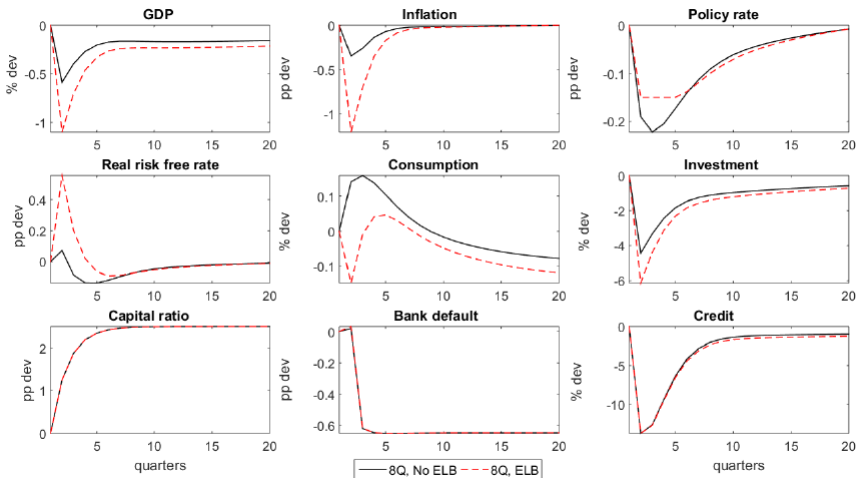
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  - 2 Equity is more expensive than debt (limited participation in bank equity market)  $\implies$  higher capital requirements at some point can reduce lending.
- *Findings:*
  - Capital requirements should be higher than in the baseline calibration (pre-crisis), but less than Basel III dictates.
  - The transition (short-run hit to output and credit) is important in this assessment. It must be weighed against the long-run benefits (banks more able to withstand adverse shocks).
  - Monetary policy is important in managing the transition.

- ① How strong are the links between the real economy and credit?
- ② What shocks are important?
- ③ How to assess model fit?
- ④ What is the role of monetary policy?

# Weak Links Between the Real Economy and Credit?



# What Shocks are Important?

- The authors intentionally abstract from aggregate shocks.
- Consequently, there are only two financial shocks:
  - ① Idiosyncratic return shocks to entrepreneurial firms.
  - ② Idiosyncratic risk on the return to banks' assets (which cannot be diversified away).
- This makes a complex model tractable.
- However, it is intuitively plausible that an aggregate shock, such as a non-financial demand shock, could be quantitatively important for the optimal level of capital.
  - In the model the probability of bank failure reflects the aggregate rate of return on loans and the idiosyncratic return shock.

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  - The authors instead show how the transition path changes with a larger standard deviation for idiosyncratic bank risk.
- The write-up of the financial shocks could be clearer. In some parts their standard deviations are denoted as time-varying - suggesting there are risk shocks.

# How Does the Model Fit?

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- We can't compare the variances of the model and the data due to the absence of aggregate shocks.
- Could whether the model captures key correlations be used?
  - Is the behavior of spreads realistic? Defaults? Comparisons to other off-model data to show model fit?
- In summary, while the findings are qualitatively sensible, it is hard to evaluate the whether they are quantitatively and more supporting evidence could be given.

# What is the Role of Monetary Policy?

- One of the arguments is that the negative real impact of lifting capital requirements can be mitigated by the conduct of monetary policy.
- This is demonstrated by comparing the outcomes from a Taylor rule with typical parameters to one responding very aggressively to inflation.
  - This is business-as-usual monetary policy.

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- One of the arguments is that the negative real impact of lifting capital requirements can be mitigated by the conduct of monetary policy.
- This is demonstrated by comparing the outcomes from a Taylor rule with typical parameters to one responding very aggressively to inflation.
  - This is business-as-usual monetary policy.
  - Monetary policy could instead deviate temporarily from the policy rule.
    - E.g. an announcement of the policy rate being lower than otherwise for the next year.
  - While microprudential policies are not typically coordinated with monetary policy, given the magnitudes of the negative real impacts during the transition coordination seems intuitively plausible.
  - More broadly, does the offset have to be done by monetary policy?

- This paper is on an interesting and important topic
- Its findings are qualitatively sensible.
- The key message is: increased resilience of the financial system from higher capital requirements in the long run must be weighed against the short-run costs to the real economy during the transition.
  - Argues that monetary policy can lessen these transition costs.



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- ③ Abstracting from aggregate shocks makes the model tractable. However, it also makes it more difficult to assess the model fit and whether the empirical findings are plausible.
  - Presenting evidence that the model captures key correlations, the behavior of spreads etc. would provide support for the quantitative implications.

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  - Presenting evidence that the model captures key correlations, the behavior of spreads etc. would provide support for the quantitative implications.
- ④ The argument that monetary policy can lessen the costs during the transition could be strengthened by considering some form of policy coordination, e.g. temporary deviations from the Taylor rule.