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# Discussion of “Fiscal Policy, Banks and the Financial Crisis”

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The usual disclaimer applies

- 
- Paper studies two very important topics:
    - role of government support to banks
    - impact of government default on real economywith a **DSGE model**
  
  - I like idea of:
    1. setting up a model
    2. estimating it (with Bayesian methods)
    3. and using it for policy analysis



# But there are limits to DSGE modeling

- Financial crisis and the debate on DSGE models
- New Keynesian framework:
  - Representative agent cash-less economy
  - nominal rigidities → role for monetary policy
  - no financial intermediation, no risk and no default
- Models are 99% of times **linear**
- “*The paradigm that has emerged [...] is one that is clearly applicable to **normal times** [...] in **developed, stable economies**”, Galí (interview for EABCN, 2009)*”



## But there are limits to DSGE modeling

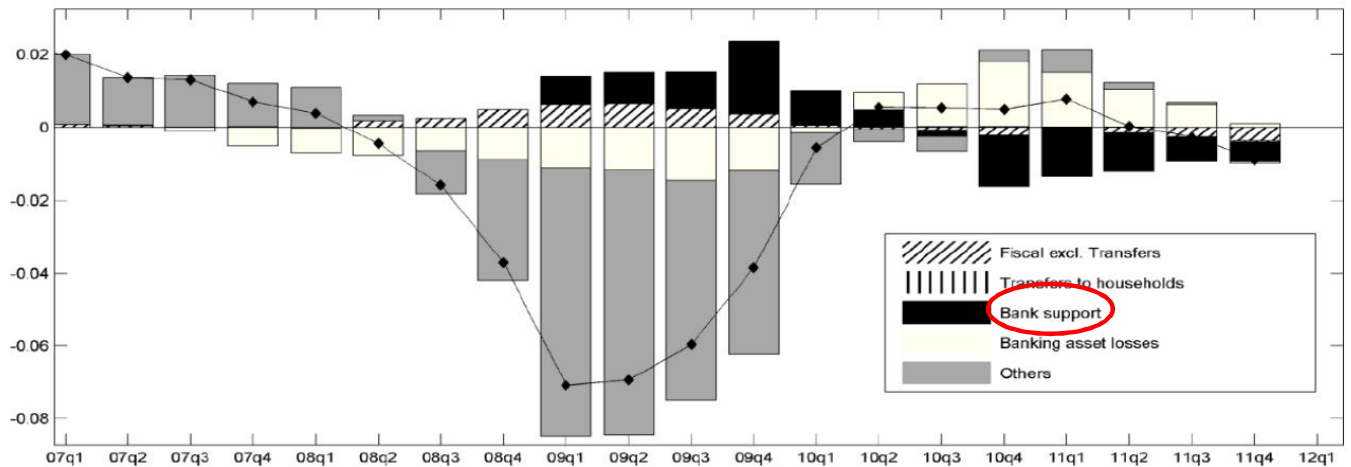
- Paper studies issues that are present only in “**exceptional times**” when economic dynamics become non-linear...
- ... and **linear** models are not useful
- But what is alternative? To wait for better and more complex models, not easy to use for empirical investigation and policy-making?
- I am with Robert and co-authors → studies key issues adapting current generation of DSGE models



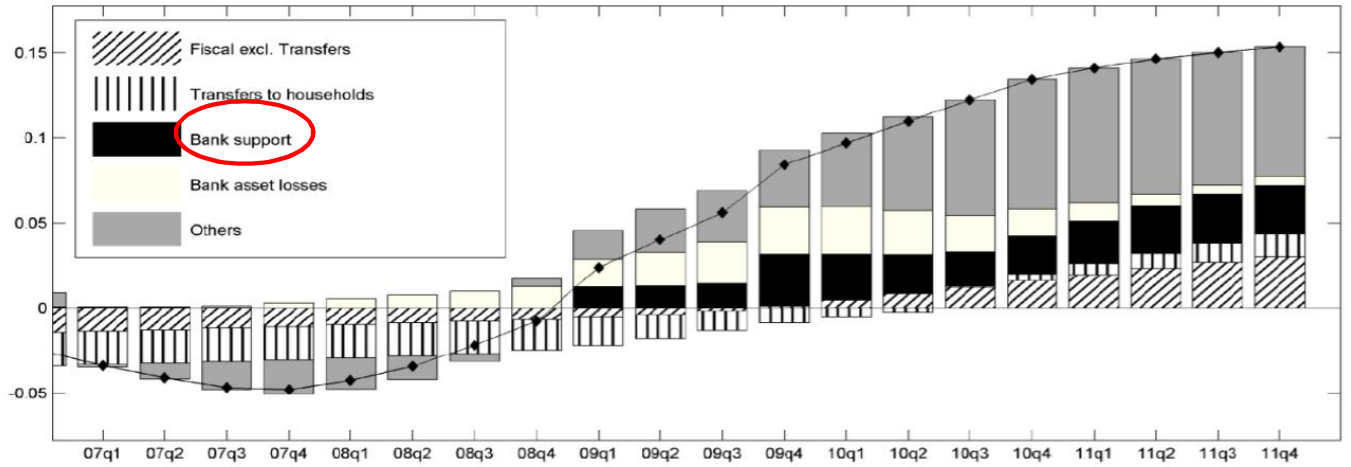
# The paper

- Study link between banking and public sectors:
  - macroeconomic effects of **banks support**
  - transmission of **sovereign defaults** to real economy
- Main results:
  - government support and sovereign default have **real effects**
  - government support contributed to **moderating euro-area recession** in 2008-09

(a) YoY GDP growth (demeaned)



(d) Debt to GDP ratio (demeaned)





# The model

- New-Keynesian **open-economy** model with **credit frictions**, **banks** and **fiscal policy**
- Banks lend to impatient households (borrowers), obtain deposits from patient households (savers) and hold domestic and foreign government bonds
- Role for **bank capital**: undercapitalized banks charge higher loan rates
- Model is **estimated** for euro area



# Comments

1. link between fiscal policy, banks and growth
2. heterogeneity within euro area
3. other





## Comments (1)

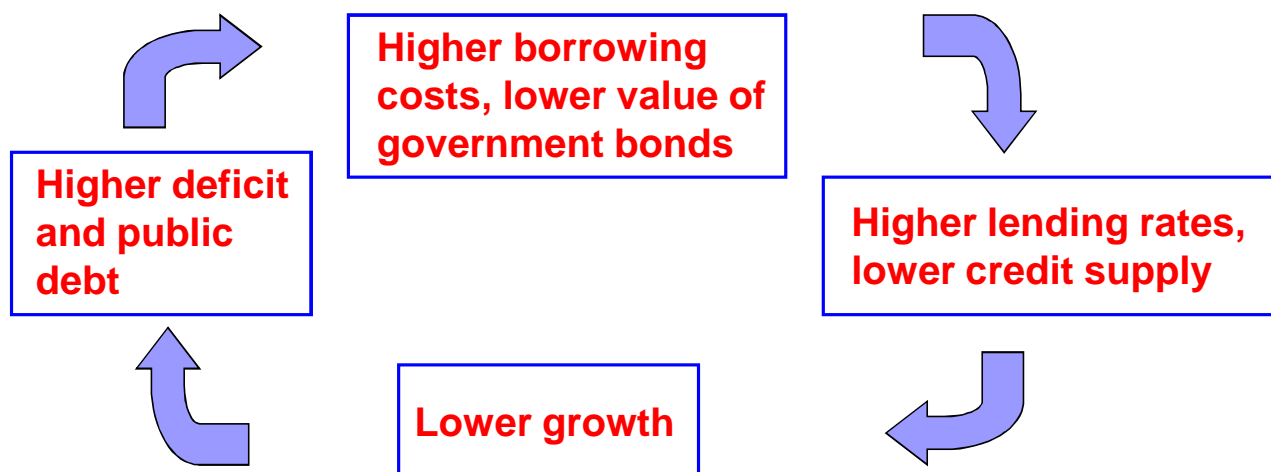
- Key missing link

gov't support to banks → **fiscal position deteriorates** → **sovereign spreads**

**increase** → lending rates increase, credit supply falls → real effects → fiscal position deteriorates → sovereign spreads increase → .....

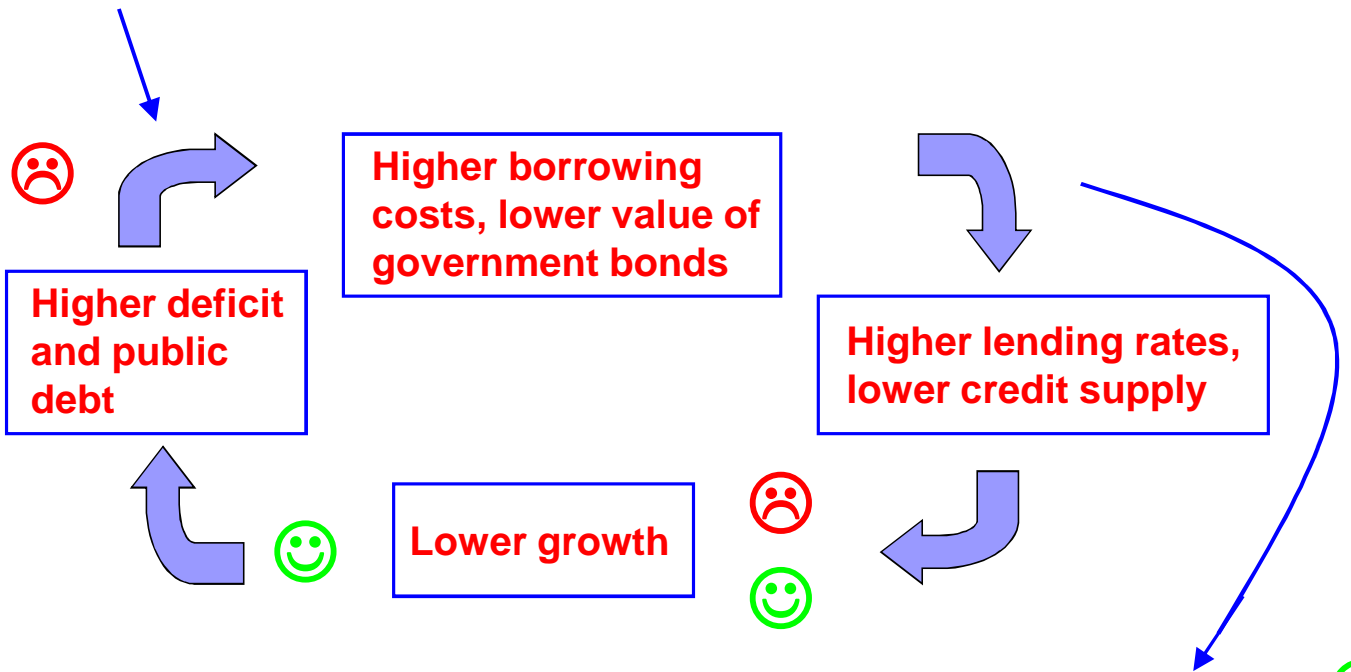
(see Ireland and Spain)

# Fiscal policy, banks and growth



Independent Commission on Banking - Vickers report: “Recent events elsewhere in Europe have illustrated that, **just as banking problems can jeopardize the fiscal position, sovereign debt problems can put banks at risk.** [...] close inter-relationship between the stability of banks and the soundness of public finances [...].”

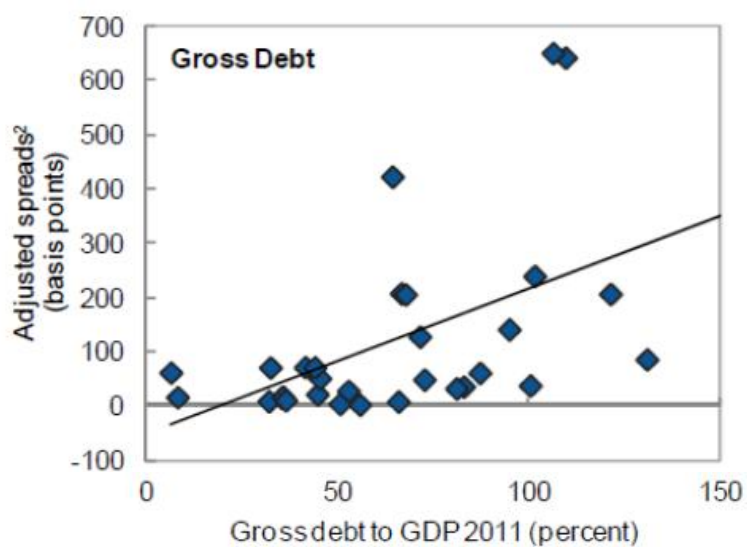
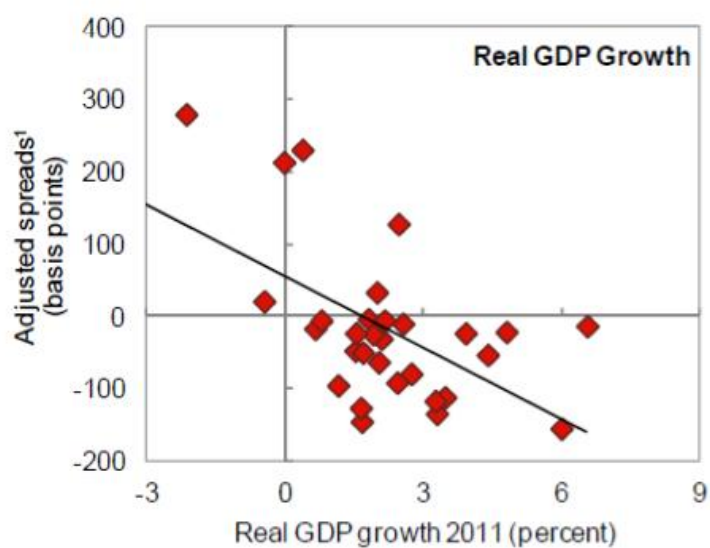
# Fiscal policy ☹️



# Unconventional monetary policy

- Balance sheet channel 😊
- Liquidity channel ☹️
- Price channel ☹️

## Real GDP growth, public debt and borrowing costs



Higher growth → lower borrowing costs

Higher debt-to-GDP → higher borrowing costs

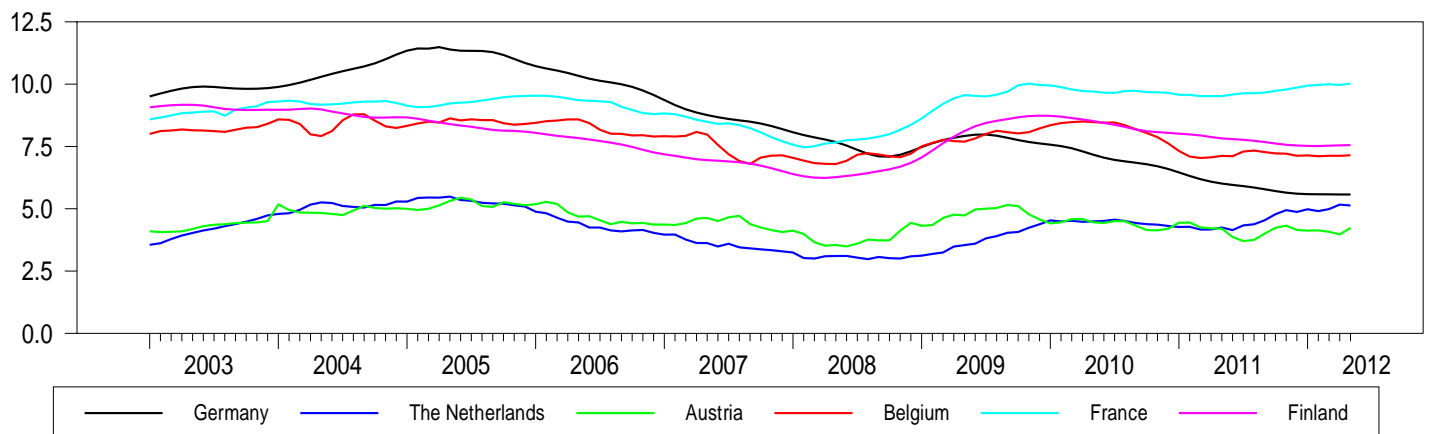
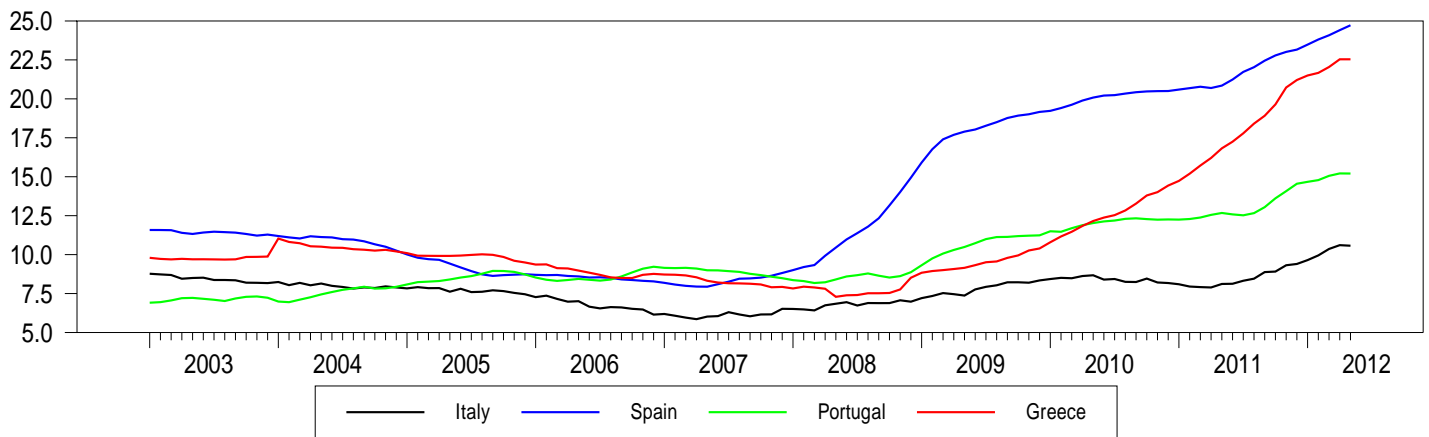
Source: Fiscal Monitor, IMF, January 2012

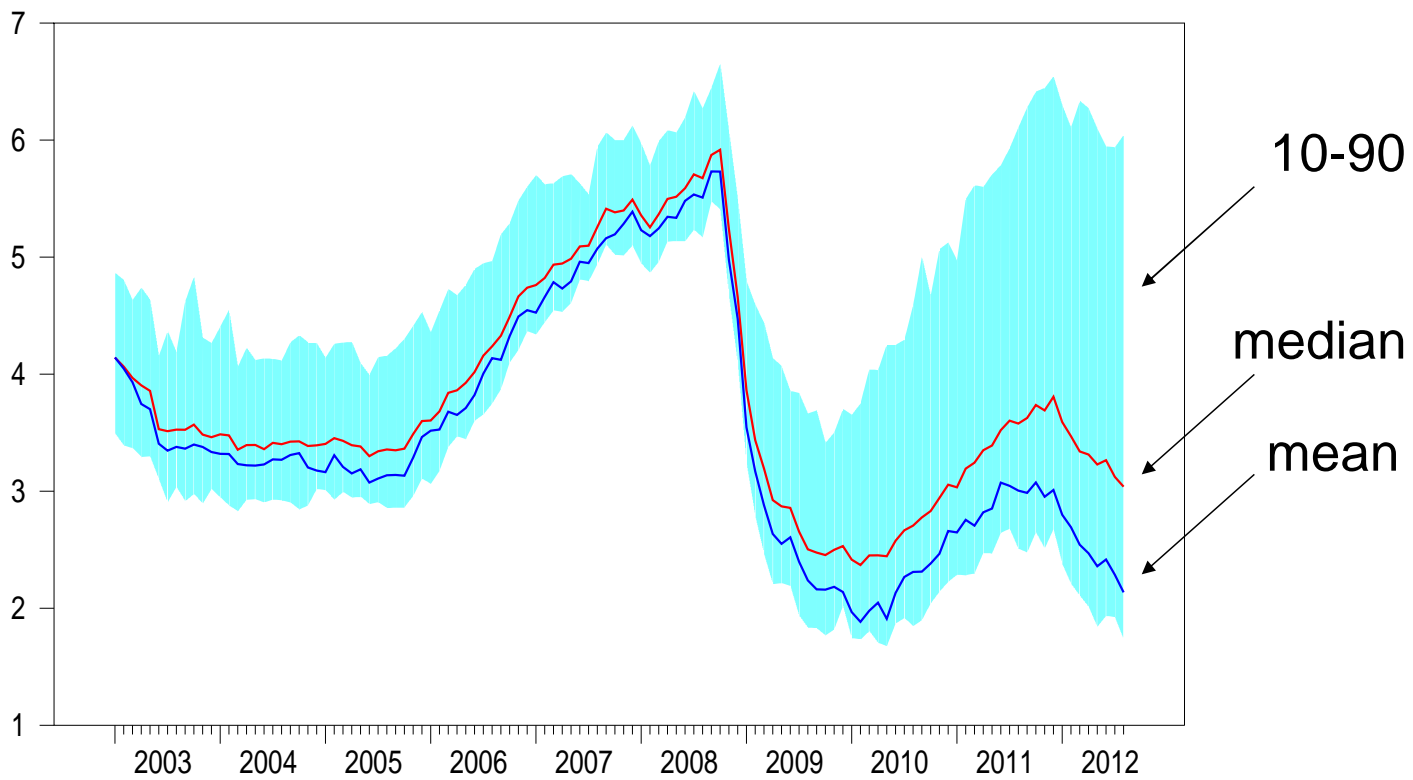


## Comments (2)

- **Heterogeneity** within euro area:
  - economic outlook
  - fiscal position
  - credit conditions (banks rates, credit developments and lending standards)
  - bank support

# Unemployment rate in selected euro-area countries

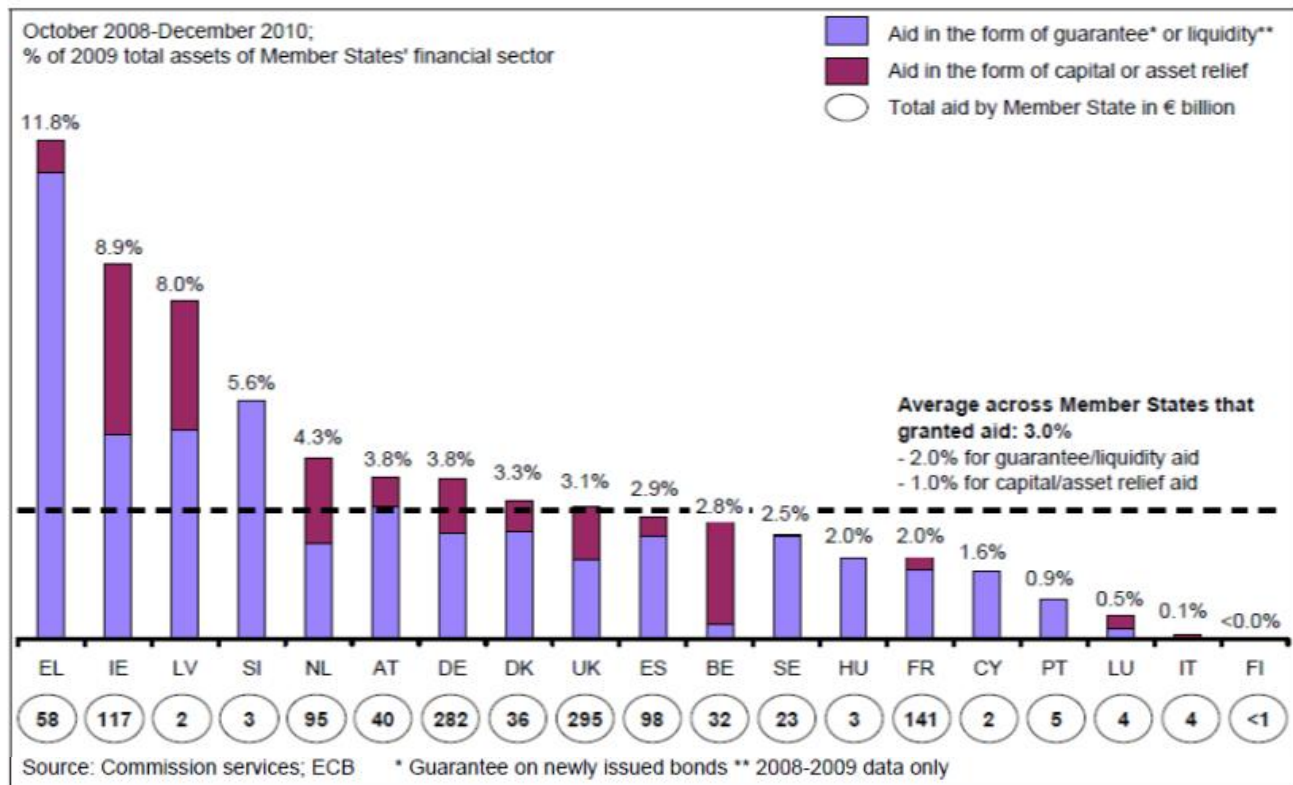




**Variable rates on loans to non-financial corporations** in the euro area

# Recapitalization heterogeneous across EU countries

**Figure 4.2: Used aid to the financial sector as a share of the size of the banking sector**







## Other comments (3)

- Shock to entrepreneur's forecast of return to capital. Why is it needed?
- What is role of habit formation in hours and housing? Why are they needed?
- Link between policy rate and bank rates not clear
- How are data transformed? No reference in paper
- Data on bank recapitalization in estimation
- ECB monetary policy during sovereign debt crisis