Discussion of Mendicino et al.: Extreme Financial Distress and the Macroeconomy

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DSGE models under siege

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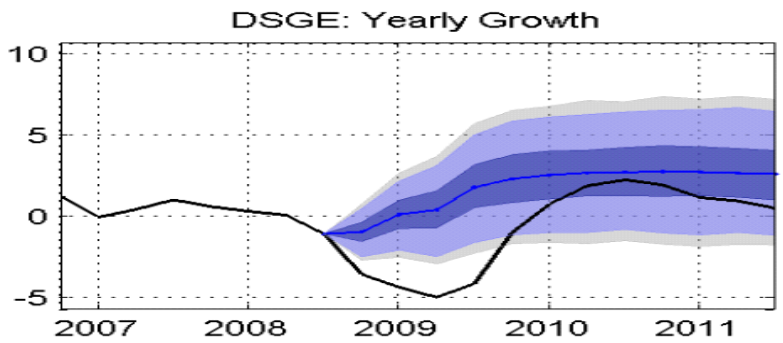
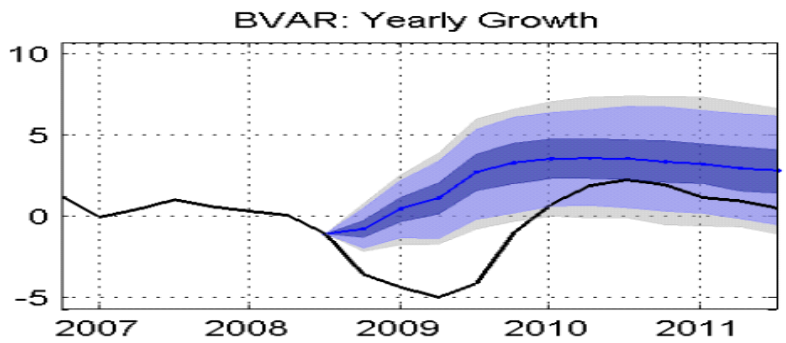
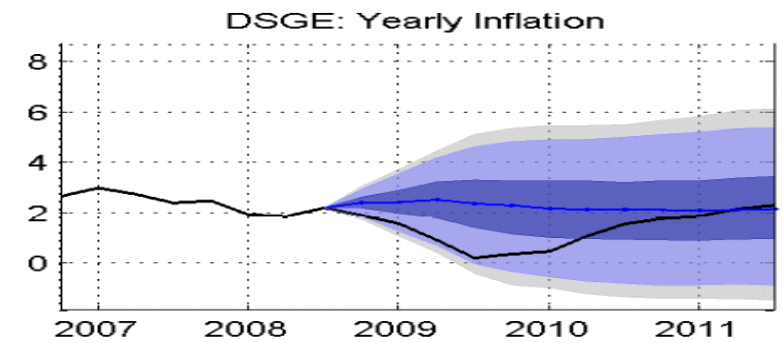
- In a 2016 paper, this year's Nobel laureate Romer launched a full attack on DSGE models:
  - *"For more than three decades, macroeconomics has gone backwards. . . models attribute fluctuations in aggregate variables to imaginary causal forces that are not influenced by the action that any person takes"* .

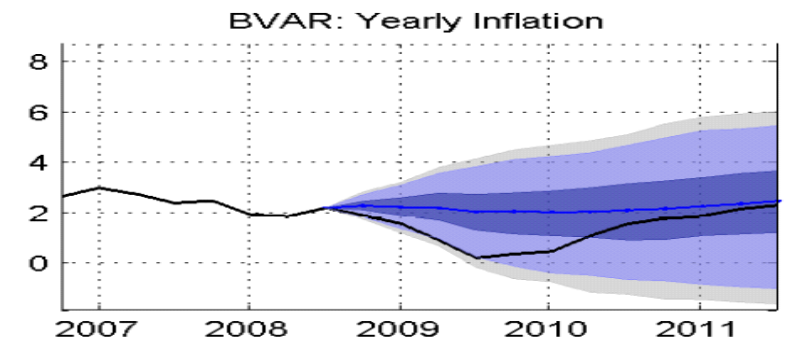
Motivation II

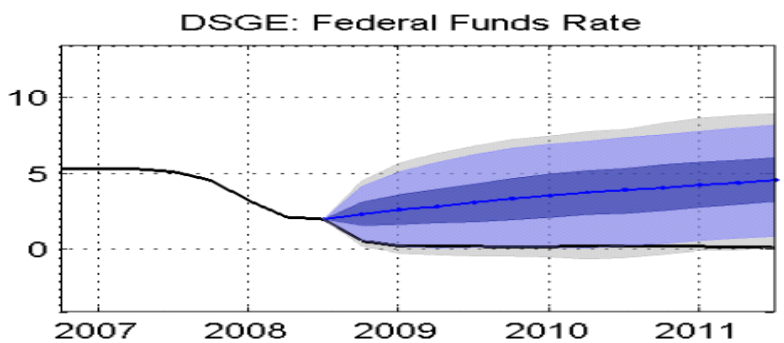
LSW (2016): coverage problem of standard linearized models without financial frictions

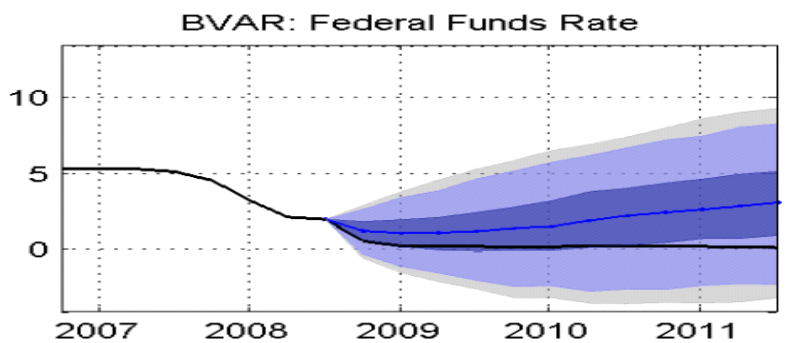












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Develop a model with financial frictions and extreme distress

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- Bottom line message: FF key for understanding macroeconomic fluctuations: both as propagation and impulses.
- A very nice and rich paper on an important topic.

My Discussion

- Comments on model
- Empirical properties of model
- Wishlist for future extensions
- Wrap up

Comments on model

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- So more ambitious targets for deposit insurances to avoid bank-runs require notably higher bank capital requirements to damp moral hazard behavior of the banks.
- Would this feature survive if you assumed bank-runs were feasible?

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- Figures 12-14 suggest that the influence of financial factors are quite sensitive to the assumed requirement; higher capital requirements makes the economy much more resilient to financial developments and are also welfare enhancing.
  - Would be interesting to explore the sensitivity of the welfare result of optimal high capital requirement to the deposit insurance schedule.

Comments on model III

Tease out partial derivative w.r.t. BGG (1999)

- I think Figures 2-5 are great to build intuition about the model.
- Still, I would really like you to include one variant with the BGG (1999) mechanism only.
- Doing so would allow you to examine how much propagation the Bank Risk-taking Channel adds relative to BGG.

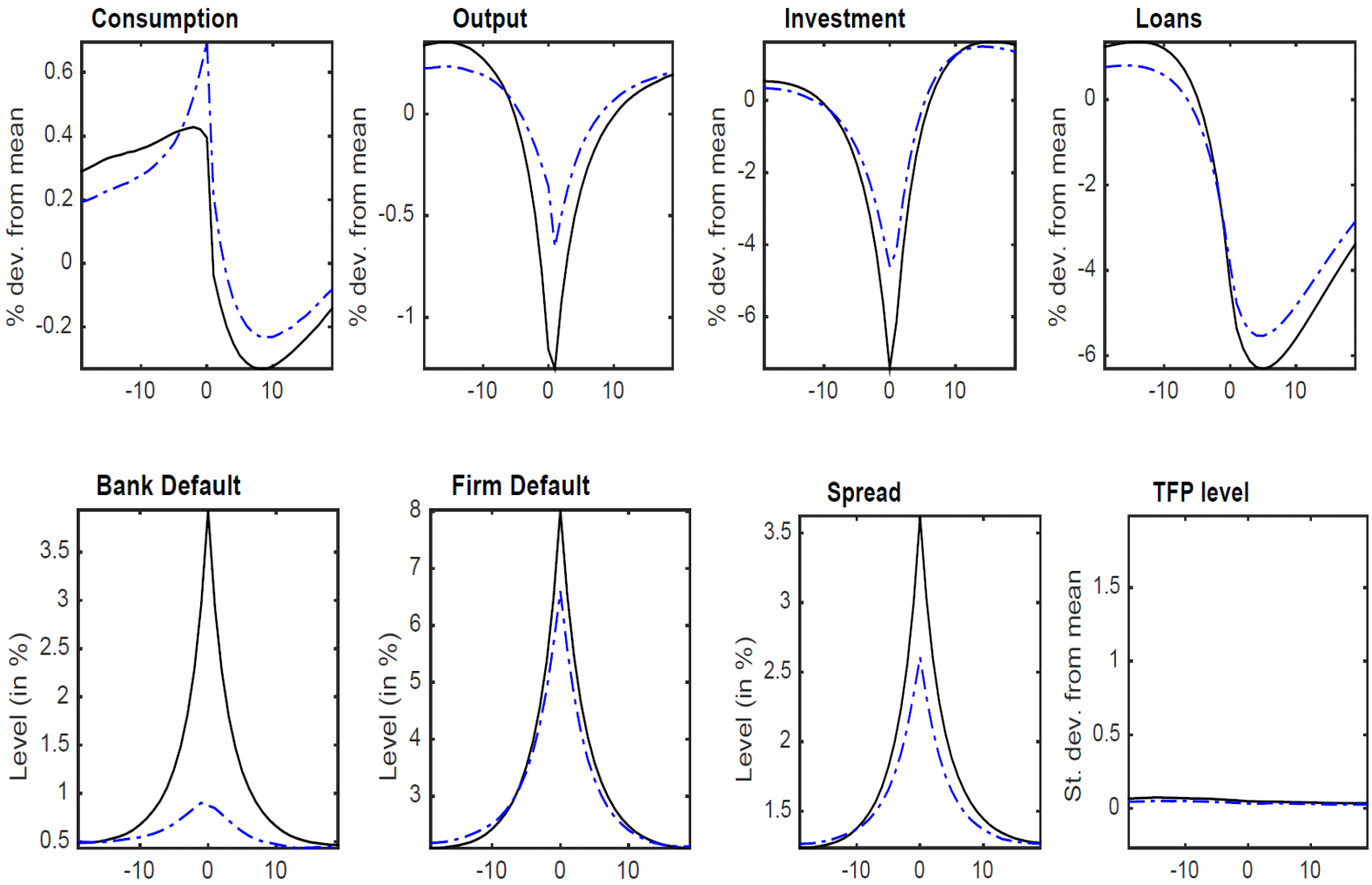
Empirical properties of model

Persistence and size of the recessions

- In Figure 8, you show the average paths for exogenous and endogenous variables conditional on 90th percentiles for firm and bank defaults.
- Consumption, output and investment falls. Investment sharply.
- The figure shows that economic downturns associated with both high levels of bank and firms default rates are more severe, and that the non-diversifiable island risk shocks are key. Firm idiosyncratic shocks are important too, but technology shocks appear basically irrelevant.

Empirical properties of model

Persistence and size of the recessions: Figure 8 in paper



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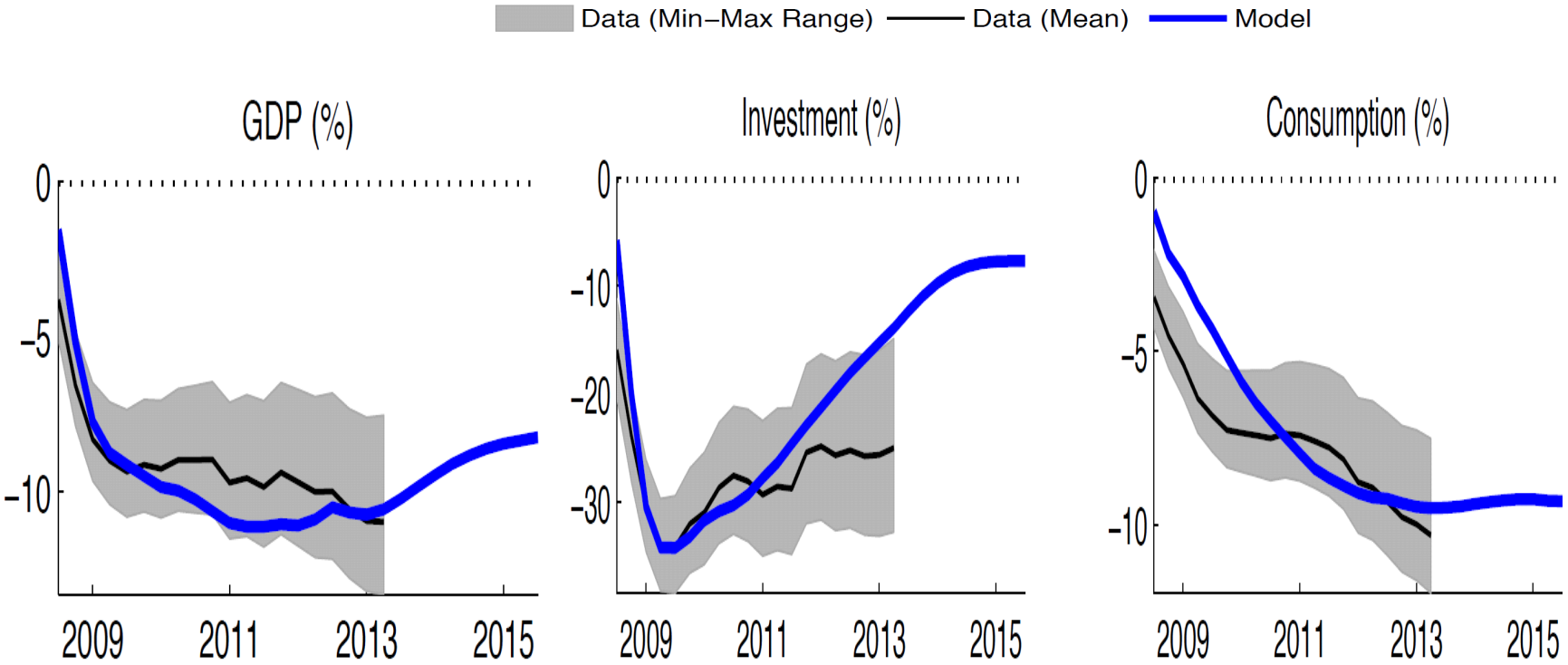
- Persistence problem might be addressed by adding autocorrelation moments to your SMM estimations.

Empirical properties of model

Persistence and size of the recessions Cont. CET evidence from the GR.

Figure 8: The U.S. Great Recession: Data vs. Model



Empirical properties of model

Selection of percentiles...

- You stress asymmetries related to the 3rd order approximation of your model.
- Judging from model distributions relative to a normal, you indeed have some interesting asymmetries in the model at the 10th and 90th percentiles.

	Empirical--Uncond.	Model--Cond.	Model-Normal Dist
Mean	0,3668	0,3313	0,3313
SD	0,5953	0,9493	0,9493
10th	-0,3015	-1,1032	-0,88528
90th	0,9161	1,2305	1,547877

- But given title of paper and the GR/EA crisis you should include lower percentiles so that we learn how the model works under extreme distress. Shortage of EA data: move to US data.

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  - Require re-estimation (and think about mechanisms to generate booms and persistent busts).

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  1. Nominal rigidities...and the ELB as an amplification factor, but also normative analysis (what mp could do).
  2. Housing and borrow constrained households as an amplification factor (and normative implications for mp).

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- Look forward to see the next draft and future follow-up papers!