Bank capital in the short and in the long run

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The views expressed do not necessarily reflect those of the Bank of Italy or of the Eurosystem.

THE PAPER IN A NUTSHELL

- Builds a quantitative macro-banking model with nominal and (non-trivial) financial frictions:
  - price stickiness & nominal debt,
  - “3D” apparatus for financial intermediation.
- Calibration to the EA economy.
- Evaluates welfare in face of increasing capital requirements (CRs):
  - in the long run (comparing steady states),
  - in the short run (simulating transition).
- Analyzes interaction with:
  - standard monetary policy,
  - speed of implementation,
  - occurrence of ZLB,
  - financial distress in the banking sector.

THIS PAPER IN A NUTSHELL

- Very topical for the current policy debate.
- Great model laboratory to analyze welfare effects of CRs.
- Provides an outlet to accommodate answers to more questions.

FOUR COMMENTS

1. Modelling: Open economy, monetary union.
2. Calibration and validation: Targets vs. correlation of key financial variables, interpretation.
3. Transitional dynamics: Occurrence of the ZLB, binding borrowing constraints.
4. What about unconventional monetary policy?

MODELLING

- The model is rich in financial frictions with explicit default risk of NFCs and, most notably, banks.

- It remains of medium scale for policy purposes:

  - higher capital requirements in a country within a monetary union may lead to ZLB-like scenarios,

  - exchange rate response to a MEI-like shock such as higher CRs may change relevantly GDP response,

  - openness is not a trivial aspect for calibration purposes: e.g., std(GDP).

CALIBRATION

- No targeted cross-correlations:
    - untargeted model-based (conditional and unconditional) cross-correlations can serve as validation (e.g., leverage and lending rates for a given loan supply).
- Calibrated STD of iid risk for entrepreneurs $>$ than for banks.
    - Interpretation? May suggest that regulation should focus more on risk weights on asset side.
    - After all, bank iid risk is reduced-form representation of unmodeled sources of risk (with matched bank-firm data you can check how much of bank-specific risk is not an aggregation of bank borrowers' risk).

TRANSITIONAL DYNAMICS

- Occurrence of the ZLB:
  - Steady-state R is calibrated far away from 0, ZLB imposed at -15 bp (or lower) from SS.
  - What happens to deposit rates and their spread over the policy rate?
  - If the ZLB is in the steady state, would the LR effects of higher CR still face a significant trade-off between deposit and equity funding?

TRANSITIONAL DYNAMICS

- Always-binding borrowing constraints may hide higher costs of transitions:
  - consider a large recessionary shock in a setting with occasionally binding constraints,
  - borrowing constraints that were slack now bind because agents burn their buffers to smooth consumption (shadow values increase),
  - add the capital requirement,
  - credit arguably gets restricted even more aggressively than in the absence of initial recessionary shocks.

$\longrightarrow$ Interaction with the phase of the business cycle is key (after all, Basel III does aim at less procyclical banks).

For welfare analysis, we might need also models where accumulating buffers (wealth away from a binding constraint) is relevant.

WHAT ABOUT UMPs?

- Forward guidance: interaction of its duration with the duration of the CRs implementation;
- PSPP: balance sheet channel of purchases of sovereign bonds; assessment of risk-taking channel (mirror of portfolio rebalancing); exit;
- CSPP: purchases of corporate debt relax lenders' participation constraint faced by NFCs, lower spreads, stimulates bank lending through GE;
- TLTROs: endogenous demand for funds, link to lending;
- Negative DFR: maximum duration of DFR given a certain CR.

Are all these really still "unconventional"?

CRs during normalization of monetary policy.

Thank you.