Comments on:
Does Currency Union Need a Capital Market Union?
by
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Question and Answer of Paper

- Q: Why and how do crises arise and spillover?
  - Which shocks/channels: financial, trade, other? What special happens in a common currency, €?
- A: Financial shocks/channel emphasized
  - Banking union is enough risk-sharing for deleveraging shocks. Capital markets (just) needed for TFP shocks
- Method: two country model, w/ shocks
  - Theoretical model, showing various shocks/scenarios

Praise for Paper

- Surely a worthwhile topic
  - Lots of questions on how financial shocks/crises affect real economies and spillover to other countries, and how followed by sovereign crises, especially in €
  - Do not know exact mechanisms/channels and thus, importantly, what to do to reduce risks/spillovers
- Praise
  - Innovative model
    - Provides economic impacts of shocks w/ different regimes
  - Useful insights for policy makers
    - Banking vs. Capital Market Unions (also vs. Fiscal?)

Comments: Sympathetic to story …. Also consistent with closed economy

- Sympathetic to "story" of paper
  - € crises, besides Greece, traditional banking crises
  - Which morphed into sovereign crises, due to:
    - Fragmentation/increased spreads hurt real economies
    - Various bank-sovereign links meant overall risks increased
  - Banking Union (BU) could have stopped some
- And model "consistent" with other analyses
  - Model ingredients consistent with financial shocks leading to domestic (secular) deleveraging, debt deflation (Fisher, Eggertsson & Krugman, etc.)

Model gets at many essentials But (NOE-)modeling is hard…

- Many essentials for issues at hand are included
  - Have savers and borrowers (most models do not
  - Banks and capital markets (many only have one
  - Various unions (BU, CMU, Complete) and shocks
  - Countries (two) can differ in various respects
- But, NOE-modeling is hard. For computable:
  - SS not unique, stationary. Modeling needs to simply
  - Log-log utility/goods. Means separation, and limited aggregate, general equilibrium feedbacks
  - Some optimizing (households), but fully flexible prices (perhaps less "NK" than claimed)

Need to simply on intermediation, policy, SOE vs. two country….

- No modeling of/role for intermediation per se
  - All lending and borrowing at risk free rate
- Some "ad-hoc" rules to close model
  - Wage setting, monetary (Taylor), passive fiscal policy
- Small open economy (SOE) vs. two country model
  - Model SOE and then check two country around SS
    - Means how much of a proxy? What is "approximately"?
    - And, apart from "math," was € in SS before or after?
  - Also make both countries identical. But large vs. small (core vs. periphery): same, more/no/less feedback?

Modeling banking and financial integration is especially hard

- "Banking Union" is what? A priori could be:
  - Foreign banks crossing borders, direct or local
  - Equal deposit rates (a common deposit insurance)
    - Or equal risk-free lending rates (is also eurobonds)
  - Sharing of large losses on assets (a resolution fund)
  - **Here**: in base model common lending interest rate

  $\Rightarrow$ **Key here: "Banks" as debt-issuers, not claimholders**
- Capital markets (note BU is subset of CM
  - Banks plus equity ownership, not just equity or debt
  - But: e.g., share of equity ownership is exogenous

What is exact scenario in this model? And how does it work?

- Simulation of a deleveraging shock
  - Shocks to borrowing limits. Yet unclear what drives it (banking collapse?). And in both countries equally?
  - What is public deleveraging (w/ no active fiscal policy)?
  - Foreign demand, interest rate shocks more obvious
- Effects run only through the savers' behavior
  - Savers will adjust according to permanent income
  - Borrowers always up to their constraints (but exogenous given, so not f(net worth or asset prices)..

$\Rightarrow$ **Savers respond to NPV (=), borrowers to constraints**

Deleveraging scenario thus gives some (surprising) effects in BU

- Savers are not affected as their NPV not affected, and prices adjust (Cole and Obstfeld, 1991)
  - Is this the well known, but special case?
- With constant interest rate (BU) no effects on C in SOE, and proximately so in two-country as pass-thru are low
  - But is pass-thru so low in €? Expect it to be high
- Monetary policy, even w/ ZLB, offsets near optimal
  - But not anywhere close to what observe (today). Why?
- Foreign demand shocks work more as expected
  - Complete > > CMU > > BU

With default, get risk-sharing, even with banking union

- Savers then bear costs of default (like equity
  - Helps reduce costs of default/debt as foreign savers do risk-sharing, therefore less debt deflation
- Foreign equity ownership of bank is equivalent
  - If banks allowed to hold debt, get risk-sharing too
- But defaults of banks have no "real costs" here
  - With no intermediation function, default irrelevant
  - But is cost not large: lost information capital, etc.?
  - And ex-ante maximize costs vs. ex-post minimize?

"Data" + Presentational Comments

- "Data" support could be clearer (here)
  - Could support more with real data/anecdotes
    - To assess assumptions realisms, tell where parameters, elasticities etc., come from. In earlier paper provided more on calibrations: use some here?
- Presentational
  - "As is" paper is "dry", less on intuition, links with €
  - Best read w/ related paper for modeling approach
  - Terms: "Small open economy" vs. two-country model

While model is supportive, can have other stories and policy implications

- Model has all the ingredients consistent with story, but "test" of channels will (always) be a horse race
  - Banking shock (=deleveraging) hurts economy
  - But other shocks (including fiscal) could harm too
  - To be sure banking is culprit, need calibrate both types
  - Can thus not "proof," but just "tell" which one it is
- And policy interpretations can vary regardless
  - Could the BU (Bank <u>or</u> Bond Union) not be a FU? As support for sovereign will also mean banking support?
    - Does EU consider ESM BU or FU? Seems more FU
  - Only risk-sharing by BU? Or by sovereign default too?