Firm-Bank Linkages and Optimal Policies in a Lockdown

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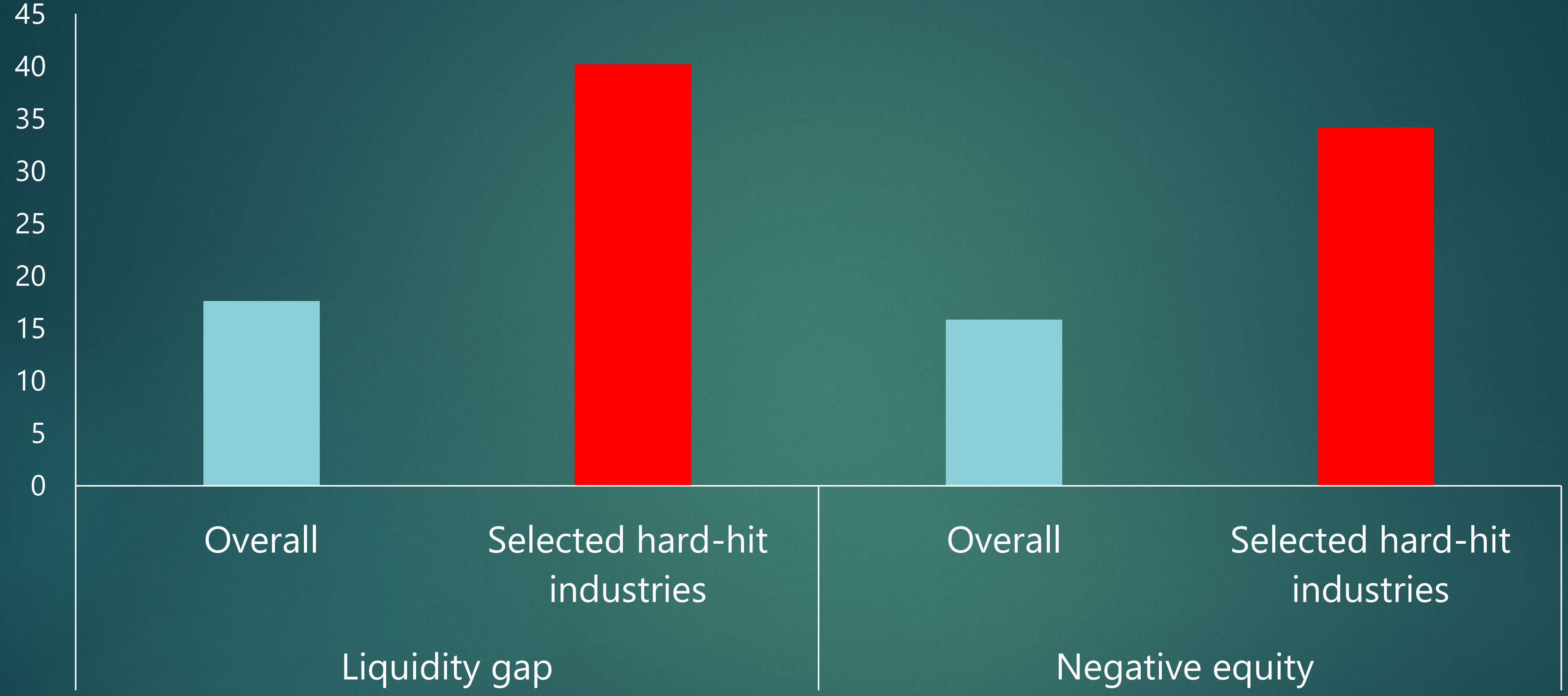
Summary

- Very interesting and timely paper. Well-written. Elegant model
- Useful framework to evaluate support policies during COVID
- Rich interaction of borrower-level and bank-level frictions
- A few suggestions:
  - Cast model more clearly in terms of solvency support
  - Discuss role of other macro policies
  - Clarify market structure / strategic interaction

Cumulative Liquidity and Insolvency Risks 2020-2021

(assuming no government support)



Forthcoming IMF Staff Discussion Note

Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies: Assessment and Policy Options

COVID: Illiquidity versus Insolvency

- This is not just a liquidity crisis
- Elements of illiquidity:
  - Knightian uncertainty about pandemic may curtail credit availability
  - Impact on financial sector (but CB policies took care of most of this)
- Immediate solvency problems for sectors most affected by crisis:
  - Transportation, tourism, entertainment,….
  - Pent up demand effects likely smaller than for other industries
  - Capacity constraints
- More widespread issues if pandemic lasts longer than expected

Policy Implications of Solvency Crisis

- Magnified moral hazard issues with liquidity support

- More difficult to justify government intervention
  - Systemic firms/sectors
  - Post-lockdown back to standard macro levers

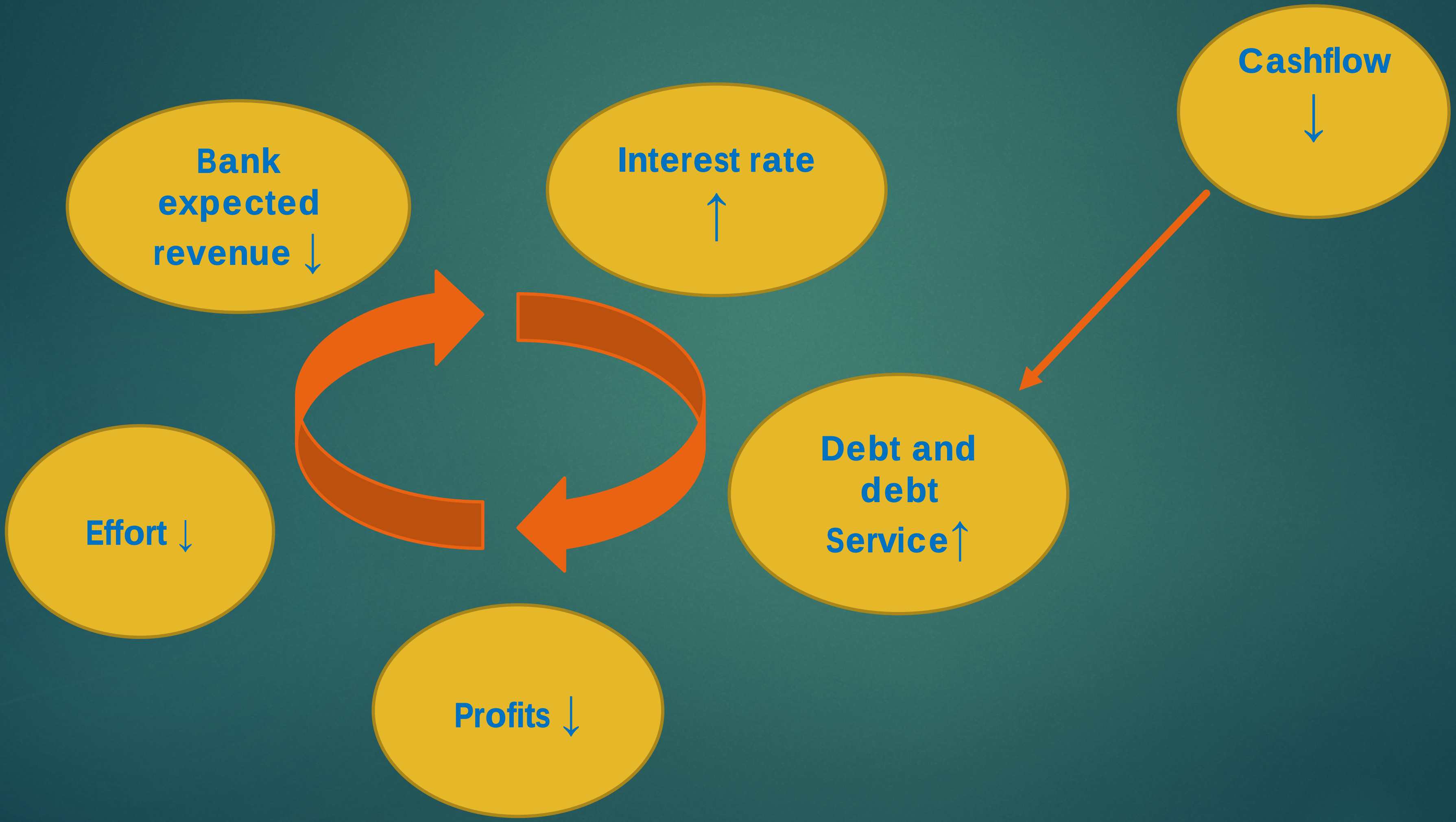
- Tradeoff between preserving economic relationships vs promoting reallocation of resources
  - Time matters

- Governance:
  - Fiscal costs likely much larger
  - Not really a job for CBs

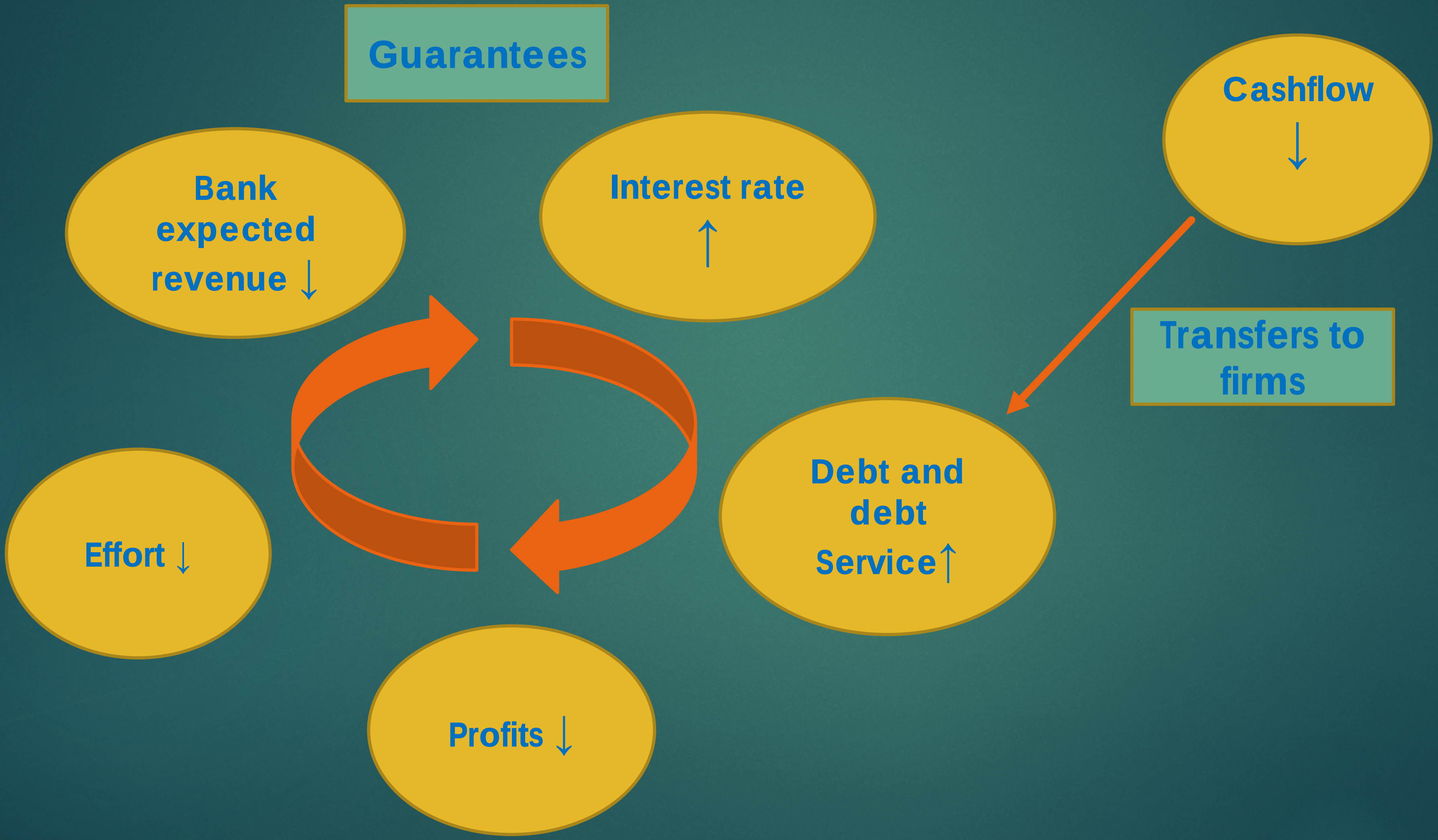
Model Basic Mechanism

- Entrepreneurs' effort unobservable: MH
  - Profits after debt service $\downarrow \longrightarrow$ effort $\downarrow \longrightarrow$ riskiness of loan $\uparrow$
  - Backward bending credit supply curve
  - **Negative balance-sheet shock may lead to rationing and inefficient liquidation**
- Deposits cannot "break the buck"
  - Banks need to remain liquid/solvent in all states of the world
  - A worse tail risk needs to be matched with higher rates
  - **Policy role to provide insurance against aggregate risk**
- **Potential for vicious spirals**

Lockdown


Bank expected revenue ↓
Interest rate ↑
Cashflow ↓
Effort ↓
Debt and debt Service↑
Profits ↓

Lockdown with support policies



More than just liquidity....

- Providing loans to borrower does not help
- Government intervention need to increase profits in case of success
- Inherent fiscal costs/constraints: Different from Diamond-Dybvig
- Incentive compatible taxation tricky (cannot just tax profits)
  - Need to distinguish between idiosyncratic and aggregate shocks

Scope of support policies

- A role for MP easing (for countries away form ZLB)?
  - Expected payment on deposits$\downarrow$ $\longrightarrow$ banks ability to lever$\uparrow$ $\longrightarrow$ borrower's profits$\uparrow$
- Solvency support in crisis vs normal times?
  - Bankruptcy helps limiting inefficient liquidation
  - Mass bankruptcies may lead to jammed system
  - $\longrightarrow$ **Rationale for solvency support in extreme systemic events**

Clarify bank market structure

- Paper considers a "competitive" bank. But does not explicitly model the banking market structure
- Bank's participation constraint imposes that profits from refinancing exceed liquidation value. What is the market structure underlying this assumption?
  - Competitive market: Other banks would provide refinancing at better terms
  - Barriers (perhaps asymmetric info): Some of the pricing assumed in the paper invalid
- It would be helpful to clarify what kind of competitive structure and strategic interaction among banks is implied in the model